1981

Statements of position of the Accounting Standards Division as of January 1, 1981

American Institute of Certified Public Accountants. Accounting Standards Division

STATEMENTS OF POSITION 1/1/81

AICPA

STATEMENTS OF POSITION OF THE ACCOUNTING STANDARDS DIVISION

AS OF JANUARY 1, 1981

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

STATEMENTS OF POSITION
OF THE
ACCOUNTING STANDARDS DIVISION

AS OF JANUARY 1, 1981

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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FOREWORD

This volume contains the Statements of Position issued by the Accounting Standards Division, as of January 1, 1981, with superseded portions deleted and amendments included. This volume is a reprint of the part of the looseleaf edition of *AICPA Technical Practice Aids* containing those Statements of Position.

ACCOUNTING STANDARDS DIVISION

DENNIS R. BERESFORD, *Chairman*
PAUL ROSENFIELD, *Director*

STATEMENTS OF POSITION ACCOUNTING STANDARDS DIVISION

Introduction

Statements of Position of the Accounting Standards Division are issued to influence the development of accounting standards in directions the Division believes are in the public interest and, in certain circumstances, to propose revisions or clarifications to recommendations on accounting standards contained in industry-oriented Audit Guides and Accounting Guides published by the American Institute of Certified Public Accountants. Statements of Position of the Accounting Standards Division do not establish standards enforceable under the Code of Professional Ethics of the American Institute of Certified Public Accountants.

In September 1979, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 32, *Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters,* an amendment of APB Opinion No. 20, *Accounting Changes.* This Statement specifies that the specialized accounting and reporting principles and practices contained in designated AICPA Statements of Position are preferable accounting principles for purposes of applying APB Opinion No. 20.

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Section 10,010

Statement of Position 74-6 Recognition of Profit on Sales of Receivables with Recourse

[Recommendation to Financial Accounting Standards Board]

AICPA

American Institute of Certified Public Accountants

1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

June 14, 1974

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying Statement of Position presents recommendations of the AICPA Accounting Standards Division on Recognition of Profit on Sales of Receivables with Recourse. It was prepared on behalf of the Division by the Accounting Standards Executive Committee for consideration by the Financial Accounting Standards Board and for such action as the Board deems appropriate.

The Statement takes the position that a uniform accounting approach is desirable for the recognition of profit or loss on sales of receivables with recourse and that the "delayed recognition" method rather than the "immediate recognition" method is preferable. This position is reached by examining the types of transactions in question, presenting the two prevalent methods of accounting for such transactions, describing the rationale supporting the use of each, and reviewing present accounting literature.

The Statement also examines the possibility that these transactions may be separated into the sale of receivables, on the one hand, and the retention of credit risks, on the other, profit and loss being allocated for each of these two elements of the overall transaction. A majority of the Executive Committee finds this method impracticable in most cases and without adequate theoretical basis. A minority finds that the technique is, under certain circumstances, not only practicable but preferable.

To: Mr. Marshall Armstrong - Page Two - June 14, 1974

Finally, the Statement sets forth recommended methods of systematic amortization for the "delayed recognition" approach and presents guidelines on disclosure for these transactions.

The Division would appreciate being advised as to the Board's proposed action on these recommendations.

Sincerely yours,

Stanley J. Scott

STANLEY J. SCOTT
Chairman
Accounting Standards Division

SJS/Lc

Enclosure

NOTES

Statements of Position of the Accounting Standards Division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of Statements of Position is to influence the development of accounting and reporting standards in directions the Division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, Statements of Position do not establish standards enforceable under the Institute's Code of Professional Ethics.

RECOGNITION OF PROFIT ON SALES OF RECEIVABLES WITH RECOURSE

INTRODUCTION

.01 The Accounting Standards Division (the Division) of the American Institute of Certified Public Accountants has reviewed the accounting practices used by business enterprises for the recognition of profit (or loss) on sales of receivables with recourse.[1] The review indicated that in current practice two accounting methods are widely used in these transactions. The review also found that both accounting methods have been in use within specific industries. These two accounting methods are discussed in the "Current Practice" section of this Statement.

.02 In recent years accountants, regulatory authorities, investors, and other users of financial statements have expressed concern over the acceptability of alternative accounting methods in accounting for similar business transactions. The Division believes that it is not desirable to have alternative accounting methods acceptable for the recognition of profit on sales of receivables with recourse. Therefore, the Division is expressing in

[1]The term *recourse* in the context of this Statement refers generally to the contractual right of a purchaser of receivables to demand payment from the seller of such receivables in the event of default by the debtor. However, the term may also refer to agreements between a buyer and a seller of receivables, such as guarantees by the seller of a "yield" to the buyer on the receivables sold, which constitute "recourse" in substance.

this Statement its position on a preferable method. Its position is set forth below under "The Division's Position."

.03 The scope of this Statement is restricted to the subject of profit (or loss) recognition on sales of receivables with recourse. This Statement does not discuss and is not intended to apply to the sale of receivables on a non-recourse basis, the recording of transactions giving rise to receivables, the imputation of interest on receivables[2] or the presentation of sales of receivables with recourse in financial statements.

.04 The Division's position as set forth herein applies to financial statements which purport to present financial position, changes in financial position, or results of operations in conformity with generally accepted accounting principles. It also applies to regulated companies in accordance with the provision of the Addendum to APB Opinion No. 2, *Accounting for the Investment Credit* (1962).

TERMINOLOGY

.05 The key terms in this Statement are defined below as they are used herein. Some additional definitions will be given as the need arises in the course of this Statement.

.06 *Receivables.* Receivables recorded under generally accepted accounting principles represent contractual rights to receive monies. They may arise from sales of products or services in the normal course of business which are due in customary trade terms (generally less than one year) and sales made pursuant to conditional sales contracts which are payable in monthly installments over periods often ranging from 3 to 10 or more years. Receivables may also arise from lending activities, such as mortgage loans for the purchase of real estate, direct cash loans to individuals, loans to businesses to finance working capital, and loans for other purposes. Certain contractual rights to receive monies, such as those related to unperformed portions of executory contracts, are ordinarily not recognized as receivables under generally accepted accounting principles.

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[2] Provisions for recognizing the appropriate rate of interest on receivables are discussed in APB Opinion No. 21, *Interest on Receivables and Payables,* and those provisions are applicable to the initial recording of transactions giving rise to receivables.

.07 *Face Amount.* The face amount is the sum of money outstanding on a legal instrument that obligates a party to pay another party a specified amount. It may be the exact amount expressed on a note, bond, conditional sales contract, etc. The face amount of a receivable may comprise some or all of the following:

(a) The sales price of goods or services sold or the amount of a cash loan.

(b) Finance charges (interest) to be collected and earned during the term of the receivable for the use of monies.

(c) Service charges assessed the debtor for initiating the receivable, including such out-of-pocket costs as filing fees and credit investigation reports.

(d) Fees for maintenance contracts purchased by the debtor and insurance premiums for various types of insurance coverage (generally credit life insurance, credit accident and health insurance, or fire and casualty insurance).

.08 *Net Receivable.* The net receivable is the *face amount* of the receivable less related unearned finance and service charges, unearned amounts applicable to executory contracts, and amounts included in the *face amount* for which the creditor's function is solely that of an agent such as insurance premiums to be collected and remitted to an insurance company. Sometimes the net receivable is equal to the *face amount.*

.09 *Executory Contract Amount.* The executory contract amount is the amount included in the *face amount* of a receivable representing the unperformed portion of an executory contract (such as a maintenance, management, or service agreement).

.10 *Agency Amount.* An agency amount is an amount in the *face amount* of a receivable representing the cost to the debtor of a service for which the seller or lender has acted only as an agent. Insurance premiums and maintenance fees may be agency amounts.

.11 *Differential.* The differential is the difference, after adjustment if necessary for executory contract and agency amounts, between the amount for which the receivable is sold and the *net receivable.* This difference is variously referred to as "endorsement fee," "participation fee," "placement fee," "interest differential," and "finance fee." In those cases where the amount of the *net receivables* exceeds the amount for which the receivables are sold, the difference is usually termed "discount" or "loss." In this Statement only the term "differential" will be used to describe the difference arising from the sale of receivables at either more or less than the *net receivables.*

BACKGROUND AND NATURE OF TRANSACTIONS

.12 Some companies occasionally or regularly "package" some or all of their receivables and sell them to financial institutions or others to meet their financing needs. There is usually a difference between the *net receivables* and the amount for which the receivables are sold. In many instances the volume of receivables sold by companies is substantial, and the differential arising from such transactions is significant in the determination of results of operations of the seller. In addition to the volume of receivables sold, the differential may be dependent on such factors as the general level of interest rates, the stated interest rate of the receivables, the credit standing of the seller, the length of the payment period of the receivables, and the type and value of any security. Often receivables are sold on a recourse basis, and the seller of the receivables is obligated to reacquire the receivables in the event of a default by the debtor. The types of recourse arrangements will be examined after the calculation of the differential is explained.

.13 The examples below illustrate how differentials may be calculated. They are presented only as illustrations. Because there are many possible variations in agreements involving the sale of receivables, the determination of the differential will depend on the circumstances in each case. Although these illustrations assume the sale of whole receivables, there may also be sales of portions of receivables or groups of receivables in bulk without specific identification. In the cases below note that Example A includes the finance charges (add-on interest) in the face amount, whereas Example B does not. Example C illustrates a contractual arrangement that includes finance charges and executory items in the face amount.

EXAMPLE A:

Sales price of goods	$10,000
Less initial payment received	1,000
Net receivable (balance to be financed on an installment contract payable over 120 months)	9,000
Add-on finance charges (14% per annum effective interest rate)	7,769
Face amount of receivable (payable $139.74 per month)	$16,769
Amount for which receivable is sold, i.e., face amount of receivable discounted to yield 10¼% to the buyer (present value at 10¼% of $16,769 payable over 120 months)	$10,464
Net receivable	9,000
Differential	$ 1,464

EXAMPLE B:

Original amount (principal) of a 6% note payable in equal monthly installments of $119.90, including interest, over 360 months	$20,000
Principal amount of 120 payments received to date of sale of receivable	3,263
Face amount and *net receivable*	$16,737
Amount for which receivable is sold, i.e., net receivable discounted to yield 8% to the buyer (present value at 8% of 240 monthly payments of $119.90)	$14,335
Face amount and *net receivable*	16,737
Differential	$(2,402)

EXAMPLE C:

Sales price of goods	$ 5,000
Credit life insurance premium for a 3 year, single premium contract	$ 150
Maintenance contract for 3 years	300
Total	5,450
Less initial payment received	500
Balance to be financed on an installment contract payable over 36 months	4,950
Finance charges at 12% per annum	968
Face amount of receivable (payable $164.39 per month)	$ 5,918
Amount for which receivable is sold, i.e., face amount of receivable discounted to yield 10% to the buyer (present value at 10% of $5,918 payable over 36 months)	$ 5,095
Net receivable ($4,950 less $300 maintenance contract fee and $150 credit life insurance premium)	4,500
Difference between the amount of proceeds and the *net receivable*	595
Less adjustment for executory item and insurance premiums ($300 maintenance contract fee and $150 credit life insurance premium)	450
Differential	$ 145

.14 When receivables are sold on a recourse basis, the form of recourse arrangements may vary. In some situations the buyer of the receivables is obligated to return any collateral security for the receivable to the seller before the seller is compelled to perform under the recourse arrangement. In other cases a mere default on payment by the debtor will obligate the seller to reacquire the receivable. In some instances the buyer of the receivables may remarket any goods it obtains by repossession and apply the proceeds therefrom against the receivable balance. In that event the seller may be required to pay any deficiency in the receivable balance remaining after the application of such proceeds. Sometimes the liability of the seller with respect to recourse provisions is limited to stipulated amounts or percentages of the receivables sold. Such partial recourse arrangements may, however, provide the buyer adequate assurance of the recovery of his investment after considering the value of the collateral securing the receivable. In addition to reacquiring the receivable, the seller may also be required to refund to the buyer a portion of the differential originally received on the defaulted receivable, thus effectively guaranteeing the buyer a stipulated investment yield. Although the form of recourse arrangements may vary, in all cases the seller retains risks.

.15 The buyer's security in these transactions is frequently derived from a provision for the temporary retention by the buyer of a portion of the amount for which the receivables are sold. Such retained amounts are often referred to as "dealers' reserves" or "hold-backs." The terms governing "dealers' reserves" are defined in the agreement between the buyer and the seller of receivables. The amount of such "dealers' reserves" may be determined by the buyer based on loss experience developed from previous transactions with the seller or others. Amounts retained in "dealers' reserve" accounts are sometimes remitted to the seller as the reserve account exceeds stipulated percentages of the uncollected receivables. Agreements may provide that the "dealers' reserves" be charged for credit losses or rebates of finance charges resulting from either early extinguishment by the debtor or default. Some agreements may limit the buyer's recourse to the seller to amounts set aside in the "dealers' reserve." However, in most cases "dealers' reserves" represent a substantial security for the buyer's investment.

.16 The agreement between the buyer and the seller of receivables stipulates which party is to perform administrative and collection functions for the receivables sold. These functions are usually referred to as "servicing." If the seller retains the servicing functions, the agreement may provide for a "servicing fee" to be paid by the buyer. If the agreement does not specifically provide for compensation to the party peforming the servicing, compensation for the future servicing will nevertheless be reflected in the amount for which the receivable is sold. Because the ultimate cost of the obligation to service is not determinable at the time of sale, the servicing provision necessarily enters into the degree of risk retained by the seller and accordingly influences the amount of the differential.

.17 Although, as previously mentioned, the unperformed portions of executory contracts are ordinarily not recognized as receivables under generally accepted accounting principles, they may be included in the face amount of the receivable. Executory contract amounts usually enter into the risks retained by the seller. Normally these amounts are refundable to the buyer in the event of default, prepayment, or cancellation of a maintenance contract, etc., by the debtor. Therefore they influence the amount for which the receivable is sold and the differential and perhaps other terms of the agreement between the buyer and seller.

.18 There may be types of financing arrangements comparable in substance to transactions involving the sale of receivables. For example, a company may obtain from a lender a firm commitment[3] to provide financing to its customer prior to closing the sales transaction with the customer. In such cases at the time the sale is closed the customer receives the products or services sold, the lender obtains a receivable, and the company receives cash or other assets from the lender. In addition to receiving proceeds equivalent to the sales price of the product or services sold, the company may receive from the lender a portion of the finance charges stated in the receivable obtained by the lender. If the company guarantees the lender against loss arising from default by the debtor, the portion of the finance charges received from the lender is in substance the differential. To take another type of example, participation agreements or factoring arrangements, if they provide for recourse, may also be comparable in substance to transactions involving the sale of receivables and give rise to differential. In such cases the concepts discussed in this Statement regarding the recognition of profit arising from the sale of receivables with recourse are equally appropriate.

CURRENT PRACTICE

.19 The following paragraphs discuss the two accounting methods commonly used by business enterprises for the recognition of profit on sales of receivables with recourse. For the purposes of this Statement, those two accounting methods are termed the "delayed recognition" method and the "immediate recognition" method. The delayed recognition method empha-

[3] Financing commitments may be obtained directly from a lender or indirectly through intermediaries such as servicing companies.

sizes the financing aspects of the transaction. The immediate recognition method considers the sale of receivables with recourse a completed transaction giving rise to immediate profit or loss.

.20 Sums obtained from the sale of receivables with recourse are sometimes treated as borrowings, with an accounting result for profit recognition similar to that in the delayed recognition method. When these transactions are treated as borrowings, the differential is not explicitly accounted for. In these cases the differential is in effect accounted for as two separate elements: an element representing interest income on the receivables and an element representing interest expense on the borrowing. The Division has not compared the borrowing treatment to the two accounting methods for recognizing profit on such sales because this Statement does not address the question of financial statement presentation for these transactions. However, much of what is said in this Statement about the delayed recognition method applies also to the borrowing treatment because of the similarity they share both in their accounting result for profit recognition and in their basic assumption, i.e., that the sale of receivables with recourse is primarily a financing transaction.

Delayed Recognition Method

.21 As stated above, the delayed recognition method emphasizes the financing aspects of the sale of receivables. The differential is recognized in the income statement in a systematic manner over a period of time usually corresponding to the term of the receivables sold. Usually no provision is recorded for refunds of differential in the event of default by the debtors or in the event of prepayment of the receivables. No separate provision for such refunds is required because the deferred differential contains an effective reserve for them. Similarly, the differential contains an effective reserve for any future administrative and collection functions to be performed by the seller. An allowance for uncollectible receivables, including estimates of expenses of and losses on repossessions, is customarily made in the accounting for receivables. This allowance remains in effect after the receivables are sold.

.22 The rationale advanced for use of the delayed recognition method includes:

(a) The sale of receivables with recourse is in substance a type of financing, in effect a borrowing by the seller.

When a selling price is negotiated, the negotiating process is analogous to that which occurs between a borrower and a lender. In determining an acceptable return for his investment, the buyer of receivables takes into account the seller's retention of certain risks and his ability to meet those risks, i.e., his credit standing. The buyer's return is then reflected in the dollar amount for which the receivables are purchased. If the receivables were never sold, the interest income on the receivables and the costs of "borrowed" funds used to finance the receivables would be recognized in results of operations over the term of the receivables. The differential represents interest income on the receivables, net of interest expense on funds effectively borrowed to finance the receivables. Therefore, the delayed recognition method accounts for the economic substance of the transaction.

(b) "Realization"[4] occurs with the passage of time as the risks retained by the seller are diminished by payments made on the receivables, which reduce the amounts subject to refund in the event of default or prepayment. Thus, recognition of differential in income should coincide with the periods in which the risks that the differential may be refundable under the recourse provision diminish.

(c) The method used for recognition of differential in income should be similar to that used by financial institutions in accounting for finance income because the differential essentially represents interest. The differential, taken together with the allowance for uncollectible accounts, represents the aggregate credits to which future losses should be charged.

.23 In its review of current accounting practices, the Division found that the delayed recognition method is used predominantly by financial institutions (e.g., finance companies, banks, and savings and loan associations). However, this method is generally not used to recognize differential when the amount for which the receivables are sold is less than the *net receivables*. Even if the differential is a negative amount, the rationale for the delayed recognition method maintains that the analogy to financing trans-

[4] See paragraphs .37-.39 for a discussion of the realization principle.

actions is valid. In such cases the buyer has negotiated a rate of interest from the seller that is higher than the rate that the seller had obtained from the debtor when the receivables were initially recorded. The buyer's higher rate discounts the receivables to a purchase price resulting in a negative differential. Negative differential is customarily termed "discount" or "loss." For those who account for sales of receivables with recourse as borrowings, the transactions involving negative differentials are simply characterized by a higher interest rate on the borrowed funds.

Immediate Recognition Method

.24 The immediate recognition method considers the sale of receivables with recourse a completed transaction giving rise to profit or loss at the time of sale. Under this method the profit or loss recognized is equivalent to the differential. A provision is made for refunds of differential in the event of default by the debtors or of prepayment of the receivables. If the seller is to perform future administrative and collection functions, a provision is made for their cost. An allowance for uncollectible receivables, including estimates of expenses of and losses on repossessions, is customarily made in the accounting for receivables, and this allowance remains in effect after the receivables are sold.

.25 The rationale advanced for use of the immediate recognition method includes:

(a) The sale of receivables with recourse is a completed transaction. It is a three-party transaction, including a seller, a lender, and a debtor. The seller is in effect acting as a broker for the buyer of the receivables and is obtaining a commission to compensate him for his services (such as writing and packaging the receivables) up to the date the receivables are sold. If there is an analogy to financing in these transactions, it is due primarily to the relationship between the lender and the debtor. The lender must be concerned about the debtor's credit standing and ability to fulfill his obligations, whereas the seller's recourse obligations are only of secondary importance to him. The differential should therefore be recognized immediately because the earning process is complete.

(b) The seller's recourse obligations are similar to a manufacturer's obligations under product warranties or guarantees. In effect, the seller guarantees the quality of the receivables sold and should account for the consequences of such a guarantee in the same manner that a manufacturer accounts for its obligations under product warranties. Provisions are made in the period of sale for refund of the differential in the event of default by the debtor or in the event of prepayment of the receivables and also for future administrative and collection functions to be performed by the seller. In addition, an allowance for uncollectible receivables is made. Immediate recognition of differential is therefore appropriate.

.26 In studying the use of the immediate recognition method the Division found that it is often employed by retailers and dealers in automobiles, mobile homes, furniture, jewelry, and home appliances and by certain companies whose primary business is servicing receivables originated by others. The Division also observed that if a seller has purchased credit insurance for protection against losses from default by the debtor, no provision is made for uncollectible accounts because the insurance company assumes those risks. In such cases, however, provision is usually made for refunds of differential resulting from default or prepayment by the debtor because such amounts are not covered by the insurance. Finally, when the immediate recognition method is used, negative differential is recognized immediately as loss. The immediate recognition of negative differential as loss is consistent with the rationale in support of this method.

.27 The Division also found certain procedures which could be categorized either as a variation of the immediate recognition method or the delayed recognition method. For example, even if differential is being allocated over the term of the receivables, there are variations in the pattern of allocation. Another variation arises when differential is deferred to the extent that the buyer has retained a "dealers' reserve," and differential is recognized as profit only as amounts are released from the reserve. In this case the pattern of release may make the technique more or less similar to either method.

.28 Although certain procedures may be categorized as variations of either method, the distinction between the two methods is nonetheless important because it defines the two ends of the spectrum of revenue recognition for sales of receivables with recourse. The significant difference between the immediate recognition method and the delayed recognition method is in their respective timing of revenue recognition. The immediate recognition method isolates an amount that is recognized as profit at the date of sale. Under the delayed recognition method no profit is recognized at the date of the sale, rather all profit is recognized over the term of the receivables.

ADDITIONAL ACCOUNTING METHOD

.29 In addition to the two accounting methods previously discussed in this Statement, the Division considered another method of accounting for profit or loss on sales of receivables with recourse. For the purpose of the following discussion, this additional accounting method is termed the "nonrecourse-market" method.

.30 The nonrecourse-market method is predicated upon the assumption that a sale of receivables with recourse has at least two distinctive aspects, the sale of the receivables and the retention of credit risks by the seller, and that profit or loss can be allocated to each aspect of the transaction. The first aspect of the transaction, the sale of receivables, is considered to be complete at the time of the exchange. The profit allocable to this aspect of the transaction is the amount of premium or discount that would have resulted from a sale of the same receivables on a nonrecourse basis. The "premium or discount" is a component of the differential. It is the equivalent of the differential if the same sale had taken place without any recourse provision. Because the sale of the receivables is considered to be complete at the time of the exchange, the premium or discount is recognized in income in the period the receivables are sold.

.31 The second aspect of the transaction is the retention of credit risks arising from the recourse provisions. Assuming that no other aspects (such as servicing) are present in the transaction, the amount of differential allocable to the second aspect of the transaction is termed the "credit risk" component. This component of the differential is deferred at the time the receivables are sold and is recognized in income as the seller's risks diminish over the period of time the receivables are to be outstanding. If either component can be measured, the value of the other may be obtained by subtraction.

.32 In some cases a transaction involving the sale of receivables with recourse may involve more than just the two aspects discussed above. For example, the seller of the receivables may continue to service the receivables sold. If a servicing fee is not specifically provided for by the agreement between the seller and the buyer, a portion of the differential received by the seller would be deferred and recognized as income by the seller over the servicing period.

.33 The theoretical basis of the nonrecourse-market method may be challenged on the ground that the isolation of a risk-free component of the differential does not accord with the contractual obligations of the seller. Under the nonrecourse-market method the credit risk component of the differential is separated at the time of the sale from the premium component, which is immediately recognized as profit. However, at that point the recourse provision applies to every dollar of differential. At any point during the term of the receivables the differential, no matter how accounted for, is refundable to the extent of a buyer's loss from default or prepayment by a debtor.

.34 In any event, the effectiveness of the nonrecourse-market method is dependent on a reasonable assessment of the various components of the differential associated with each aspect of the transaction. The Division found that in certain cases data was available to compare the sale of receivables with and without recourse. In some cases, when the receivables are sold without recourse, the buyer insures them with an independent insurance company. If the nonrecourse-market method were to be applied to sales with recourse, the credit risk component of the differential could be measured by the insurance premium that would be paid to insure a buyer of receivables purchased without recourse against default by the debtor. In a limited number of cases information is available about the amount for which specific receivables can be sold on either a recourse or nonrecourse basis, with the difference in the two amounts being attributed to retention of the credit risks. In most cases, however, the Division believes that such measurements would not be objective because insurance rates are influenced by competitive forces within the insurance industry, because within a single industry the risk of default on receivables varies according to the proportion of the debtor's obligation that is met by his down payment, because the risk of default also varies according to the nature of collateral security provided by the seller, and because of other factors. Even when there is a difference between the prices at which receivables are offered for sale with and without recourse, such difference may be attributable to the financial strength of the seller as well as to the characteristics of the receivables being offered for sale.

PRESENT ACCOUNTING LITERATURE

.35 The Division found in existing pronouncements of the American Institute of Certified Public Accountants and the Financial Accounting Standards Board no definitive guidance on accounting for profit or loss on sales of receivables with recourse. In fact, no specific pronouncement has been devoted exclusively to these transactions. However, the Division also examined recent pronouncements on applicable general principles to see if they provided clear guidance. The following paragraphs summarize the applicable general principles.

Revenue and Profit Recognition

.36 The concepts of revenue realization are discussed in Accounting Principles Board Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises* (paragraphs 148 through 153). Realization is described as follows: "Revenue is generally recognized when both of the following conditions are met: (1) the earning process is complete or virtually complete, and (2) an exchange has taken place" (paragraph 150). The term "earning" is described as "a technical term that refers to the activities that give rise to the revenue—purchasing, manufacturing, selling, rendering service, delivering goods, allowing other entities to use enterprise assets, the occurrence of an event specified in a contract, and so forth" (paragraph 149). APB Statement No. 4 holds that the realization principle requires that revenue be earned before it is recognized as income. Monies received or amounts billed in advance of the delivery of goods or performance of services are reported as unearned revenue until the earning process is complete.

.37 According to APB Statement No. 4, revenue may not be recognized without an exchange, and the timing of revenue recognition is generally determined by the time of the exchange. For example, revenue from the sale of a product is generally recognized upon delivery of the product to the customer; revenue from services is recognized when the services have been performed;

revenue from the sale of assets other than products is recognized at the date of the sale; and revenue from permitting others to use a business's resources (such as interest, rent, and royalties) is recognized as time passes or as the resources are used.

.38 In order for a sale to result in recognizable profit, the collection of the sale price must be assured. Accounting Research Bulletin No. 43 states, "Profit is deemed to be realized when a sale in the ordinary course of business is effected unless the circumstances are such that the collection of the sales price is not reasonably assured." This statement was reaffirmed in paragraph 12 of APB Opinion No. 10 in which the APB concluded that the installment method of recognizing revenue is not acceptable unless the circumstances are such that the collection of the sales price is not reasonably assured.

The Current Trend

.39 The Division noted in recent pronouncements issued by the AICPA an increasing emphasis on deferring the point at which the earning process is considered to be complete and revenue and profit are recognized. This trend is evidenced by the accounting concepts set forth in the AICPA industry accounting guides *Accounting for Franchise Fee Revenue, Accounting for Profit Recognition on Sales of Real Estate, Accounting for Retail Land Sales,* and *Accounting for Motion Picture Films* and in FASB Statement No. 13, *Accounting for Leases.* According to these publications the completeness of the earning process may be determined based on such factors as (a) the transference from the seller to the buyer of the risks and rewards of ownership in the asset sold and (b) the seller's continuing involvement in the property sold (e. g., an obligation to perform services without reasonable compensation, guaranteeing a return to the buyer, or an obligation by the seller to repurchase the property sold). [As amended, effective January 1, 1977, by FASB Statement No. 13.]

.40 The Division also noted that accounting literature stresses that the economic substance of a transaction should determine the method of accounting (including the timing for revenue and profit recognition) if the economic substance of the transaction differs from its legal form. APB Statement No. 4 states, "Accountants emphasize the substance of events rather than their form so that the information provided better reflects the economic activities represented."

THE DIVISION'S POSITION

.41 The Division finds persuasive the rationale advanced for use of the delayed recognition method. Sales of receivables with recourse have significant characteristics of financing transactions in which monies are borrowed and assets are pledged as security thereon. This conclusion is based on the fact that the seller's risks have not been diminished by the sale transaction and on the fact that the differential has the attributes of finance income. The seller's risks are retained by the recourse provision, which also effectively pledges his assets as security for the sum advanced by the buyer. The differential represents primarily the difference between the value of the interest on the receivables sold and the value of the interest on the funds advanced by the buyer. The interest rate at which the buyer is willing to advance funds to the seller reflects the fact that risks are retained by the seller and also reflects his credit standing. These considerations are implicit in a lending transaction. The Division therefore concludes that the use of the delayed recognition method is preferable to the use of the immediate recognition method.

.42 For reasons outlined earlier in this Statement the Division questions the theoretical basis of the nonrecourse-market method and believes that practical problems usually prevent reasonable measurement of the components of the differential. It therefore believes the method should not be accepted. A minority of three members of the Accounting Standards Executive Committee dissents from this position. They believe that there are situations where the credit risk component is clearly measurable and in those instances the nonrecourse-market method is practicable and preferable.

Application of the Delayed Recognition Method

.43 The variations that the Division noted in the patterns of recognizing deferred differential suggest that divergent accounting treatments are in use. The Division therefore offers in this section its views on how the delayed recognition method should be applied.

.44 Use of the delayed recognition method calls for the amortization to operations of the differential as the risks of the seller diminish, thereby recognizing income as the earning process is completed. In order to recognize the diminishing risks of the seller the differential must be divided into its two essential elements, interest income and interest expense.[5] The differential can then be amortized by obtaining the net result of the accounting for the two essential elements. Although this division is necessary in order to account for income as risks diminish, in the financial statements the differential should be presented as a net amount.

.45 The Division believes the element equivalent to interest expense should be accounted for as is customary in accounting for the cost of borrowed funds, that is, by application of a constant rate of interest to the amount outstanding at the beginning of a given period. The amortization to operations of the element equivalent to interest income should recognize the costs and diminishing risks of the seller. This may be achieved by any of four procedures. The choice of the most appropriate procedure should be governed by the circumstances. The interest income element may be accounted for by application of a constant rate of interest to the amount of receivables outstanding at the beginning of a given period. It may also be accounted for, depending upon the circumstances, by using one of the three methods provided by the AICPA Industry Audit Guide *Audits of Finance Companies.* According to this Guide, interest income, referred to as "deferred finance income," may be accounted for by the combination method, the effective yield method without transfer, and the pro rata method with transfer. The Guide also presents criteria for the use of other methods that may be more practical in certain circumstances.

.46 The Division recognizes that at times the buyer's recourse to the seller for defaults by the debtor or refunds of differential may be limited to specific maximum amounts (e.g., the amount in a "dealers' reserve") which will cause practical problems in application of the delayed recognition method in the manner described in the preceding paragraph. If it is not practicable to

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[5] Allowances for uncollectible receivables are not part of the differential and should be accounted for separately. They are customarily made in the accounting for the unsold receivables and remain in effect after the receivables are sold, unless the risks of default by the debtor are assumed by others (e.g., a credit insurer). After the receivables are sold, allowances for uncollectible receivables should be adjusted as necessary.

Differences arising between the financial accounting for periodic recognition of profit or loss on sales of receivables and the income tax accounting for such profit or loss should be treated as timing differences in accordance with APB Opinion No. 11, *Accounting for Income Taxes.*

divide the differential into interest income and interest expense elements, the differential may be amortized by approximating the collections of the receivables and taking differential into income as the risks are thereby diminished. The goal of amortizing the differential to operations as the seller's risks diminish may be approximated by the sum-of-digits method when the receivables are payable in regular, equal installments.

.47 Direct costs incurred during the sale of receivables with recourse may be deferred and amortized to operations on a basis that will match such costs with the amortization of the differential. Costs directly incurred during the consummation of these sales (such as legal fees and costs of preparing and processing documents for transferring ownership of the receivables to the buyer) are similar to costs that might be incurred in the issuance of debt. These costs must be distinguished from the direct or indirect costs incurred in order to derive revenue from the sale of goods or service.

Disclosure

.48 The Division believes that disclosures for the sale of receivables with recourse should follow the requirements of FASB Statement No. 5, *Accounting for Contingencies.* In general, disclosure should include the nature and amount of the receivables sold during each period in which an income statement is presented, specifying the payment terms, and the amount of any receivables still outstanding at the date of the latest balance sheet presented. In addition, the financial statements should disclose the terms of the agreements, describing the conditions that would compel the seller to perform under the recourse provisions and any provisions for "dealers' reserves." The amount of funds in the "dealers' reserves" at the date of the latest balance sheet presented should also be given. [As amended, effective July 1, 1975, by FASB Statement No. 5.]

.49 The Division believes that a company's accounting policy for profit or loss on the sale of receivables with recourse should be disclosed in accordance with the provisions of APB Opinion No. 22, *Disclosure of Accounting Policies.* The amount of differential included in each period for which an income statement is presented and the amount deferred at the date of the latest balance sheet presented should also be disclosed.

ACCOUNTING STANDARDS EXECUTIVE COMMITTEE

June 14, 1974

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Section 10,020

Statement of Position 74-8 Financial Accounting and Reporting by Colleges and Universities

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Section 10,020

Statement of Position 74-8 Financial Accounting and Reporting by Colleges and Universities

[Proposal to Financial Accounting Standards Board to Amend AICPA Industry Audit Guide on Audits of Colleges and Universities]

AICPA

American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

August 31, 1974

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

Proposal to Amend the AICPA Industry Audit Guide on Audits of Colleges and Universities

Two recent publications on college and university financial accounting and reporting have endorsed expansion, clarification and revision of the AICPA Industry Audit Guide on Audits of Colleges and Universities (Audit Guide) in certain respects. The new publications are College and University Business Administration -- Administrative Service, published in May, 1974 by the National Association of College and University Business Officers, and Report of the Joint Accounting Group, published in March, 1974 by the Western Interstate Commission for Higher Education.

Members of the AICPA Accounting Standards Task Force on Colleges and Universities participated in a consultative capacity in the development of both publications and the Task Force has prepared the accompanying Statement of Position. Its purpose is to bring to your attention amendments to the Audit Guide recommended by the Task Force to conform the guide to the new publications and to request that the profession be advised, by whatever means seems appropriate, whether FASB concurs with the proposed amendments.

The amendments would give effect to the revenue, expenditure, and transfer descriptions and classifications set forth in Part 5 of the Administrative Service. They would be consistent with recommendations in those respects in the Report of the Joint Accounting Group.

Issuance of this Statement of Position will help to apprise independent auditors and others who are interested in college and university accounting and financial reporting matters of the existence of the two new publications and of the recommendation of the Task Force as to the appropriate corresponding amendment of the Audit Guide. We urge, however, as a further and more conclusive step that FASB advise the accounting profession at an early date as to whether it believes the proposed amendments are appropriate and should be regarded as having the same authoritative support as if they had been included in the Audit Guide initially. A prompt indication to the profession is especially desirable in view of the extensive recent distribution of the two aforementioned publications and in anticipation that some institutions may want to adopt the revised classifications in their fiscal 1974 financial statements.

Members of the Task Force will be glad to meet with you or your representatives to discuss these proposals. It would appreciate being advised as to the Board's proposed action on its recommendations.

Sincerely yours,

ACCOUNTING STANDARDS TASK FORCE
ON COLLEGES AND UNIVERSITIES

Jay H. Anderson, Chairman
Delford W. Edens
Daniel D. Robinson
Russel F. Viehweg

NOTES

The American Institute of Certified Public Accountants has issued a series of industry-oriented Audit Guides that present recommendations on auditing procedures and auditors' reports and in some instances on accounting principles, and a series of Accounting Guides that present recommendations on accounting principles. Based on experience in the application of these Guides, AICPA Task Forces may from time to time conclude that it is desirable to change a Guide. A Statement of Position is used to revise or clarify certain of the recommendations in the Guide to which it relates. A Statement of Position represents the considered judgment of the responsible AICPA Task Force.

To the extent that a Statement of Position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the Audit Guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the Task Force.

To the extent that a Statement of Position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the Task Force are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the Task Force believes would be in the public interest.

AUDITS OF COLLEGES AND UNIVERSITIES

Proposed Amendment to Industry Audit Guide

BACKGROUND INFORMATION

.01 At the time of final editing of the Industry Audit Guide on *Audits of Colleges and Universities* (Audit Guide) in June, 1973, the Committee of AICPA members which prepared the Audit Guide was aware of discussions then in progress among members of the Accounting Principles Committee of the National Association of College and University Business Officers (NACUBO) and the National Center for Higher Education Management Systems (NCHEMS) concerning the classification of revenues and expenditures in higher education financial accounting and reporting. The Preface of the Audit Guide mentions that the guide was developed with the coordination and cooperation of representatives of NACUBO. Special provision for future modification of revenue, expenditures and transfer categories was incorporated at the beginning of the chapters in the Audit Guide on current funds revenues, expenditures and transfers by inserting: "the following categories have been endorsed for current use by the National Association of College and University Business Officers."

.02 The fundamental accounting principle relating to presentation of revenues and expenditures which was adopted by the Audit Guide Committee was that *revenues should be classified by source* and *expenditures by function.* The Committee felt that, as long as this basic classification philosophy was adhered to, any reasonable amount of detail of revenues, expenditures and transfers desired by the industry would be agreeable to the accounting profession. The detailed categories of revenues, expenditures and transfers shown in the Audit Guide reflected the most recent recommendations of NACUBO at that time and deviated somewhat from those displayed in the 1968 revised edition of *College and University Business Administration,* or *CUBA* (1968). *CUBA* (1968) was published by the American Council on Education and, until publication of the Audit Guide by the AICPA in August 1973 and Part 5 of *College and University Business Administration—Administrative Service* (Administrative Service) by NACUBO in May 1974, was regarded as the major authoritative pronouncement on college and university accounting and financial reporting.

.03 Efforts were launched in the summer of 1969 by NACUBO to revise *CUBA* (1968). Efforts were under way at NCHEMS to prepare a Higher Education Finance Manual (HEFM), a project sponsored by the U.S. Office of Education to provide, among other things, procedures and formats for reporting financial data needed for planning and management at the institutional as well as state and federal government levels. A meeting of representatives of each of three interested groups (NACUBO, NCHEMS and AICPA) resulted in the concept of a joint effort to identify and clarify areas of difference and explore mutually satisfactory ways of developing more uniformity. The Chairman of the AICPA Committee which had developed the Audit Guide and two other members of that Committee, which officially dissolved in October, 1973, were invited to become members, along with NACUBO and NCHEMS representatives, of a new Joint Accounting Group (JAG) to carry out these objectives.

.04 JAG's work was completed with the publication by the

Western Interstate Commission for Higher Education, Boulder, Colorado, in March, 1974 of the *Report of the Joint Accounting Group*. The primary recommendation of that report was that, with the exception of current funds revenues, expenditures and transfers, higher education institutions should utilize the accounting definitions and practices outlined in the Audit Guide. The JAG report in Appendixes I and II set forth recommended revenue, expenditure and transfer category descriptions which represented a revision of those presented in the Audit Guide. The JAG also recommended that its revised revenue, expenditure and transfer categories be incorporated into the Audit Guide and the new Administrative Service. The categories recommended by the JAG were later used by NACUBO in its preparation of Part 5 of the new Administrative Service. Thus the report of the JAG was an initial step toward the inclusion of the revised revenue, expenditure and transfer categories in the new Administrative Service which the Task Force now considers more current than those included in the Audit Guide.

.05 The JAG was formed in the summer of 1973 and at the same time, at the request of officials of NACUBO, the Accounting Standards Division of the AICPA organized a Task Force, consisting of four of the members of the former Audit Guide Committee (including the three individuals participating with the JAG), to consult with NACUBO's Accounting Principles Committee regarding the revision of *CUBA* (1968). This revision was published as a section (Part 5) of the new looseleaf Administrative Service. It can be obtained by subscription from NACUBO, Suite 510, One Dupont Circle, Washington, D.C. 20036. The new Administrative Service replaces *CUBA* (1968) as the major authoritative pronouncement on college and university accounting and financial reporting published by the industry.

.06 Both the NACUBO and JAG efforts were conducted in close coordination with each other and involved overlap of representatives of AICPA, NACUBO and NCHEMS. Both of these projects involved a certain amount of refinement of revenue, expenditure, and transfer definitions and classifications. However, no deviations from the fundamental accounting principles, auditing procedures or standards of financial statement presentation from those set forth in the Audit Guide were advocated in the two publications. Neither of the publications deals at all with auditing standards. The participation of AICPA Committee and Task Force members in these two publication efforts was geared to provide the two primary constituencies (NACUBO and NCHEMS) with background information and explanations about the content of the Audit Guide and to assist them in making sure that their publications did not deviate from the basic accounting principles and standards of financial reporting contained in the Audit Guide. Even though the JAG report and the new Administrative Service reflect different literary styles, the Task Force members who were involved in the consulting projects believe that those publications do not contain any significant deviations from the accounting principles and reporting standards reflected in the Audit Guide. The Audit Guide concept of revenues by source and expenditures by function has been followed.

RECOMMENDATION

.07 The Task Force believes that the descriptions and classifications of revenues, expenditures and transfers, as they pertain to current funds, set forth in Chapters 5:2 (Current Funds), 5:6 (Chart of Accounts) and 5:7 (Illustrative Exhibits) of the new Administrative Service should be recognized by practitioners as representing more current descriptions and classifications than those presented in the Audit Guide and that, until such time as the Audit Guide is revised, independent auditors should refer to those parts of NACUBO's new Administrative Service, which are appended to this Statement of Position, in connection with current funds revenue, expenditure and transfer account descriptions and classifications.

.08 Specifically, the Task Force believes the Audit Guide should be considered as being superseded by the Administrative Service as follows:

a. Pages 20-24 of Chapter 5, Current Funds Revenues, of the Audit Guide, through the section on Expired Term Endowments, should be superseded by the section Current Funds Revenues beginning on Page 2 of Chapter 5:2, Current Funds, of the Administrative Service.

b. Pages 26-30 of Chapter 6, Current Funds Expenditures and Transfers, of the Audit Guide, through the section on Other Transfers—Unrestricted Current Funds, should be superseded by the section on Current Funds Expenditures and Transfers, beginning on Page 6 of

Chapter 5:2, Current Funds, of the Administrative Service.

c. The Illustrative Financial Statements in Exhibits A-C on Pages 60-72 of the Audit Guide should be superseded by Chapter 5:7, Illustrative Exhibits, of the Administrative Service.

d. The section of Chapter 5:6, Chart of Accounts, of the Administrative Service, beginning with Current Funds Revenues Accounts through the end of Page 10, should be added to the Audit Guide as Appendix A.

.09 The Task Force further believes that adoption of the expanded descriptions and classifications should be effective for all fiscal years beginning after June 30, 1974 and that earlier adoption should be permissible.

.10 CURRENT FUNDS*

[Chapter 5: 2]

THE CURRENT FUNDS group includes those economic resources of a college or university which are expendable for the purpose of performing the primary missions of the institution—instruction, research, and public service—and which are not restricted by external sources or designated by the governing board for other than operating purposes. The term "current" means that the resources will be expended in the near term and that they will be used for operating purposes.

The Current Funds group has two basic subgroups—unrestricted and restricted. Unrestricted current funds include all funds received for which no stipulation was made by the donor or other external agency as to the purposes for which they should be expended. Restricted current funds are those available for financing operations but which are limited by donors and other external agencies to specific purposes, programs, departments, or schools. Externally imposed restrictions are to be contrasted with internal designations imposed by the governing board on unrestricted funds. Internal designations do not create restricted funds, inasmuch as the removal of the designation remains at the discretion of the governing board.

The distinction between unrestricted and restricted funds is maintained through the use of separately balanced groups of accounts in order to provide acceptable reporting of stewardship to donors and other external agencies. This distinction also emphasizes to governing boards and other sources of financial support the various kinds of resources of the Current Funds group that are available to meet the institution's objectives.

Separate accounting entities may be provided for auxiliary enterprises, hospitals, and independent operations in either the Unrestricted Current Funds or Restricted Current Funds subgroup or both, as appropriate.

Assets, Liabilities, and Fund Balances of Current Funds

Assets usually consist of cash, accounts receivable, including unbilled charges, notes receivable, undrawn appropriations, in-

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* From *College and University Business Administration,* third edition (Washington, D.C., 1974), by permission of the National Association of College and University Business Officers.

vestments, amounts due from other fund groups, inventories, prepaid expenses, and deferred charges. "Unbilled charges" are those which have been earned but which, because of inadequate information, incomplete projects or programs, or the timing of the billing cycle, have not been formally billed at the balance sheet date. "Undrawn appropriations" are those to which the institution is entitled, but which have not been remitted or made available to the institution by the appropriating federal, state, or local agency. "Deferred charges" are expenditures that are related to projects, programs, activities, or revenues of future fiscal periods.

Liabilities usually consist of accounts and notes payable, accrued liabilities, deposits, amounts due to other fund groups, and deferred credits. Accrued liabilities include such items as interest, wages, salaries, and taxes. Deferred credits are those revenues of unrestricted current funds that are applicable to a future period, when they become earned.

The individual assets and liabilities, but not the fund balances, of unrestricted and restricted current funds are sometimes combined for reporting purposes, but if they are combined, the borrowings between unrestricted and restricted funds should be disclosed by footnote or other appropriate means.

The fund balances may be subdivided to show allocations applicable to auxiliary enterprises, hospitals, independent operations, outstanding encumbrances, other allocations by operating management or by the governing board, budget balances brought forward from prior fiscal periods, and the unallocated balance.

Changes in the balances of unrestricted current funds include the gross amount of all unrestricted revenues and expenditures applicable to the reporting period, as determined in accordance with the accrual basis of accounting, and transfers to and from other fund groups for the period. Significant allocations of unrestricted current fund balances should be disclosed.

The fund balances of restricted current funds should be classified in the accounting system to show the various classes and sources of funds and purposes of restriction. Such restrictions often relate to the use of endowment fund income; gifts, grants, and contracts from private and governmental sources; and legislative appropriations. Further breakdowns may be provided to show amounts restricted to auxiliary enterprises, hospitals, and independent operations, if such activities are the beneficiaries of restricted current funds.

Additions to fund balances of restricted current funds arise from the sources indicated in the preceding paragraph. Deductions from restricted fund balances result from:

1. Direct expenditures and mandatory transfers.
2. Refunds to donors and other external agencies.
3. Amounts transferred to unrestricted revenues representing indirect cost recoveries on appropriate programs.
4. Nonmandatory transfers.

Current Funds Revenues

Current funds revenues include (1) all unrestricted gifts, grants, and other resources earned during the reporting period and (2) restricted resources to the extent that such funds were expended. Current funds revenues do not include restricted current funds received but not expended or resources that are restricted by external persons or agencies to other than current funds.

Interdepartmental transactions between service departments and storerooms and other institutional departments or offices should not be reported as revenues of the service departments but rather as reductions of expenditures of such departments, since these transactions are essentially interdepartmental transfers of costs. The billed price of services and materials obtained from service departments and central stores by offices and departments of the institution should be accounted for as expenditures of those offices and departments, just as if they had been obtained from sources outside the institution. Any difference between costs and billed prices as recorded in the service department account, whether credit or debit, should be reported under the Institutional Support expenditures classification.

Certain intrainstitutional transactions, however, should be reflected in the operating statements of the institution as revenues and expenditures. Materials or services produced by an instructional department as a by-product of the instructional program and sold to other departments or to auxiliary enterprises or hospitals—for example, milk sold by the dairy department to the dining halls—should be treated as sales and services revenues of the selling department and as expenditures of the receiving department. Sales and services of auxiliary enterprises to other departments—for example, catering by the food services department in the entertainment of institutional guests and sales by the college store to instructional departments—should be treated as sales and services revenues of the respective auxiliary enterprises and as expenditures of the unit receiving the services or materials.

Unrestricted and restricted current funds revenues should be grouped into the following major classifications by source of funds:

Tuition and Fees
Federal Appropriations
State Appropriations
Local Appropriations
Federal Grants and Contracts
State Grants and Contracts
Local Grants and Contracts
Private Gifts, Grants, and Contracts
Endowment Income
Sales and Services of Educational Activities
Sales and Services of Auxiliary Enterprises
Sales and Services of Hospitals
Other Sources, *including expired term endowments and expired life income agreements, if not material; otherwise, separate category*
Independent Operations

Tuition and Fees

This category should include all tuition and fees assessed against students (net of refunds) for educational purposes. Tuition and fees should be recorded as revenue even though there is no intention of collection from the student. The amounts of such remissions or waivers should be recorded as expenditures and classified as Scholarships and Fellowships or as staff benefits associated with the appropriate expenditure category to which the personnel relate.

When specific fees are assessed under binding external restrictions for other than current operating purposes—for example, debt service on educational plant or on renewals, replacements, or additions to plant—they should be reported as additions to the appropriate fund group (in the above example, plant funds), since they are not legally available for current operating purposes. Fees normally are not considered as assessed under binding external restrictions unless there is an explicit representation to the individuals remitting the fees that the fee or a specific portion thereof can be used only for the specific nonoperating purpose.

If some portion of total tuition or fee receipts is pledged under bond indenture agreements, the total receipts should be reported as unrestricted current funds revenues and the pledged amount treated as a mandatory transfer to plant funds.

If some portion of tuition or fees is allocated by action of the governing board, or subject to change by the governing board alone, for other than operating purposes, such as financing construction, the whole of the tuition charges or fees should be recorded as unrestricted current funds revenues and the portion allocated should be treated as a nonmandatory transfer to the appropriate fund group (in the above example, plant funds).

Revenues pledged under bond indenture agreements should not be reported as additions to plant funds, but should be reported as unrestricted current funds revenues, and funding of debt service requirements treated as mandatory transfers.

If an all-inclusive charge is made for tuition, board, room, and other services, a reasonable distribution should be made between revenues for tuition and revenues for sales and services of auxiliary enterprises.

Revenues from tuition and student fees of an academic term that encompasses two fiscal years—for example, a summer session—should be reported totally within the fiscal year in which the program is predominantly conducted.

If tuition or fees are remitted to the state as an offset to the state appropriation, the total of such tuition or fees should be deducted from the total for state appropriations and added to the total for tuition and fees.

Governmental Appropriations

This category includes (1) all unrestricted amounts received for current operations from, or made available to an institution by, legislative acts or local taxing authority and (2) restricted amounts from those same sources to the extent expended for current operations. This category does not include governmental grants and contracts. Amounts paid directly into a state or local retirement system by the appropriating government on behalf of the college or university should be recorded as revenue of the institution. This category does not include institutional fees and other income reappropriated by the legislature to the institution.

The determination of whether a particular government appropriation should be classified as restricted or unrestricted funds is based on the ability of the governing board of the institution to effect a change in the intended use of the funds. If a change in a particular restriction can be made without having to go through the legislative process, the funds should be considered unrestricted. Funds are unrestricted even if they are distributed to the institution for purposes specified by an intermediate group, such as the governing board. In this case, if a change in the use of funds needs to be made, it can be made by the intermediate body without going through the legislative process; the funds therefore would be unrestricted. Such appropriations should be considered unrestricted funds unless the restrictions are so specific that they substantially reduce the institution's flexibility in financial operations. Appropriations in terms of major object classes or to colleges and branch institutions should be classified as unrestricted current funds.

Governmental appropriations should be classified to identify the governmental level—federal, state, or local—of the legislative body making the appropriation to the institution. The fundor level is the level of the agent that makes the decision that the moneys will be appropriated to the particular purpose for which they ultimately are expended. For example, if the federal government stipulates a specific use for some funds that merely flow through the state to the institution, the funds should be classified as federal funds. However, if the federal government distributes funds to the state for unspecified general purposes—for example, general revenue sharing—and the state then appropriates all or a portion of those funds, the funds received by the institution should be classified as state rather than federal funds.

Governmental Grants and Contracts

This category includes (1) all unrestricted amounts received or made available by grants and contracts from governmental agencies for current operations and (2) all amounts received or made available through restricted grants and contracts to the extent expended for current operations.

Amounts equal to direct costs incurred by restricted current funds should be recorded as revenues of those funds, while amounts equal to associated indirect cost recoveries should be reported as unrestricted current funds revenues.

The government fundor level should be disclosed using the same criterion described for governmental appropriations.

Private Gifts, Grants, and Contracts

This category includes amounts from nongovernmental organizations and individuals, including funds resulting from contracting for the furnishing of goods and services of an instructional, research, or public service nature. It includes all unrestricted gifts, grants, and bequests as well as all restricted gifts, grants, and contracts from nongovernmental sources to the extent expended in the current fiscal year for current operations. Gifts, grants, and contracts from foreign governments should be treated as private gifts, grants, and contracts. Income from funds held in revocable trusts or distributable at the direction of the trustees of the trusts should be reported as a separate revenue source under this classification. This category excludes revenues derived from contracts and other activities, such as utility services, that are not related directly to instruction, research, or public service.

Amounts equal to the direct costs incurred by restricted current funds should be reported as revenues of those funds, while amounts equal to the associated indirect cost recoveries should be recorded as unrestricted current funds revenues.

Endowment Income

This category includes:

1. Unrestricted income from endowment and similar funds.
2. Restricted income from endowment and similar funds to the extent expended for current operations.
3. Income from funds held by others under irrevocable trusts, which should be identified separately under this revenue heading.

The unrestricted income from investments of endowment and similar funds credited to unrestricted current funds revenues should be the total ordinary income earned (or yield), except for income that must be added back to the principal in accordance with the terms of the agreement of donation. If endowment fund investments include real estate, the income should be reported on a net basis after allowing for all costs of operating and managing the properties.

Income from investments of endowment and similar funds does not include capital gains and losses, since such gains and losses are accounted for in the Endowment and Similar Funds group as additions to and deductions from fund balances. If any portion of the gains of endowment or quasi-endowment funds is utilized for current operating purposes, the portion so utilized should be reported as a transfer rather than as revenue (see Chapter 5:3).

When investments of endowment and similar funds are pooled, the amounts reported as revenues of unrestricted current funds and as additions to restricted current funds should be substantially equal to the amounts earned during the fiscal period and attributable to the various funds.

Many institutions have established endowment income stabilization reserves to spread or allocate current investment income. Two methods have been followed in establishing such reserves.

Under one method, a portion of the total revenue from the investment pool is not allocated to the participating funds, but is set aside in a stabilization reserve; the balance of the investment pool revenue is distributed to the participating funds. This method is not in accordance with generally accepted accounting principles for the following reasons:

1. The balance in the stabilization reserve may represent undistributed income attributable to both restricted and unrestricted current funds. Thus the balance in the reserve cannot be reported accurately in the financial statements.
2. To the extent any of the undistributed income earned during the fiscal year is attributable to unrestricted current funds, an understatement of revenues of unrestricted current funds will occur.
3. Questions might arise as to the authority of the governing board to withhold amounts of income attributable to, but not distributed to, restricted current funds.

Institutions carrying balances in endowment income stabilization reserves created under this method should dispose of them as appropriate.

The second method, which conforms to generally accepted accounting principles, would distribute *all* income from the pools to the participating funds. The amount applicable to unrestricted current funds would be reported as endowment income. Any amounts set aside for a stabilization reserve should be shown as an allocation of the unrestricted current funds balance and appropriately reflected in the balance sheet as a subdivision of that balance. Amounts applicable to restricted current funds should be reported as an addition to those fund balances. The amounts expended from such balances should be shown as revenues of endowment income in the restricted current funds. Amounts unexpended would remain as balances to be carried forward to the next period.

Sales and Services of Educational Activities

This category includes (1) revenues that are related incidentally to the conduct of instruction, research, and public service and (2) revenues of activities that exist to provide an instructional and laboratory experience for students and that incidentally create goods and services that may be sold to students, faculty, staff, and the general public. The type of service rendered takes precedence over the form of agreement by which these services are rendered. Examples of revenues of educational activities are film rentals, sales of scientific and literary publications, testing services, and sales of products and services of dairy creameries, food technology divisions, poultry farms, and health clinics (apart from student health services) that are not part of a hospital. Revenues generated by hospitals (including health clinics that are a part thereof) should be classified as sales and services of hospitals.

If sales and services to students, faculty, or staff, rather than training or instruction, is the purpose of an activity, the revenue should be classified as sales and services of auxiliary enterprises or hospitals.

Sales and Services of Auxiliary Enterprises

This category includes all revenues generated through operations by auxiliary enterprises. An auxiliary enterprise is an entity that exists to furnish goods or services to students, faculty, or staff, and that charges a fee directly related to, although not necessarily equal to, the cost of the goods or services. The general public incidentally may be served by some auxiliary enterprises.

Auxiliary enterprises usually include residence halls, food services, intercollegiate athletics (if essentially self-supporting), college unions, college stores, and such services as barber shops, beauty parlors, and movie theaters. Even though they may serve students and faculty, hospitals are classified separately because of their size and relative financial importance.

This category is limited to revenues derived directly from the operation of the auxiliary enterprises themselves. Revenues from gifts, grants, or endowment income restricted for auxiliary enterprises should be reported under their respective source categories.

Sales and Services of Hospitals

This category includes revenues (net of discounts, allowances, and provision for doubtful accounts) generated by hospitals from daily patient, special, and other services. Revenues of health clinics that are part of a hospital should be included in this category. Not included are revenues for research and other specific-purpose gifts, grants, or endowment income restricted to the hospital. Such funds should be included in the appropriate revenue sources described above.

Other Sources

This category should include all sources of current funds revenue not included in other classifications. Examples are interest income and gains and losses on investments in current funds, miscellaneous rentals and sales, expired term endowments, and terminated annuity or life income agreements, if not material.

Note: It is appropriate to subtotal all revenues described above; the subtotal excludes revenues of independent operations.

Transfers from Other Funds

Unrestricted amounts transferred from other fund groups back to the Current Funds group are not revenues of the current funds. An example is the return of quasi-endowment funds from the endowment and similar funds to unrestricted current funds. Such amounts should be identified separately and included in Nonmandatory Transfers (see expenditure categories).

Independent Operations

This category includes all revenues of those operations which are independent of, or unrelated to, but which may enhance the primary missions of the institution—instruction, research, and public service. Included are revenues associated with major federally funded research laboratories and other operations not considered an integral part of the institution's educational, auxiliary enterprise, or hospital activities. This category does not include the net profit (or loss) from operations owned and managed as investments of the institution's endowment funds.

Additions to Fund Balances

The term "additions" is in contrast to revenues and transfers. Additions are amounts received or made available to the restricted current funds during the reporting period as distinguished from the amounts of restricted funds expended during the fiscal period, which are reported as restricted fund revenues.

Current Funds Expenditures and Transfers

Current funds expenditures represent the costs incurred for goods and services used in the conduct of the institution's operations. They include the acquisition cost of capital assets, such as equipment and library books, to the extent current funds are budgeted for and used by operating departments for such purposes. If the amount of ending inventories or the cost of services benefiting subsequent fiscal periods is material (in terms of effect on financial statements), both inventories and deferred charges should be recorded as assets and previously recorded expenditures appropriately decreased. In a subsequent fiscal period these inventories and deferred charges as consumed should be included as expenditures of that period. Significant inventories of materials are usually present in central stores.

A capital asset is defined as any physical resource that benefits a program for more than one year. Capital expenditures therefore include funds expended for land, improvements to land, buildings, improvements and additions to buildings, equipment, and library books. Most institutional accounting systems provide for recording at least a portion of capital expenditures in the current fund expenditures accounts of the various operating units. Whether an expenditure is to be considered a capital expenditure is generally a matter for institutional determination, or in the case of some public institutions, it is prescribed by state regulation.

The general criteria for defining a capital asset are the relative significance of the amount expended and the useful life of the asset acquired, or in the case of repairs and alterations, the extent to which the useful life is extended. For expenditure reporting purposes, any item costing more than a specific amount, as determined by the institution or appropriate governmental unit, and having an expected useful life of more than one year generally should be classified as a capital expenditure.[1]

Interdepartmental transactions ordinarily should be accounted for as an increase in current fund expenditures of the department receiving the materials, services, or capital assets and as a decrease in current fund expenditures of the transferring department. Thus, total institutional expenditures are not inflated by the transactions. Examples are sales and services of service departments and central stores and transfers of material and equipment from one department to another. Any differences between the revenue from sales and services and the operating costs of service departments or central stores, whether debit or credit, are treated as Institutional Support expenditures. On the other hand, sales and services of an auxiliary enterprise to another department or auxiliary enterprise, or sales of materials produced by an instructional department to another department or auxiliary enterprise, would be reported as an expenditure of the department or auxiliary enterprise receiving the materials or services and as revenue of the department or auxiliary enterprise selling the materials or services.

Expenditures differ from transfers. Expenditures are the

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[1] The Cost Accounting Standards Board (CASB) has stipulated $500 and a useful life of more than two years as the threshold at which items must be considered capital assets, and Federal Management Circular 73-8 (formerly OMB Circular A-21) defines equipment as items having an acquisition cost of $200 or more and an expected service life of one year or more. Different limits which are reasonable and consistently applied are acceptable.

recognition of the expending of resources of the Current Funds group toward the objectives of each of the respective funds of that group. Transfers are amounts moved between fund groups to be used for the objectives of the recipient fund group. There are two types of transfers, mandatory and nonmandatory, which are fully described later in this chapter.

Expenditures and transfers may be classified in a variety of ways to serve a variety of purposes. Some of the factors bearing on the desired classification are:

1. The context in which appropriations, gifts, grants, and other sources of revenue are made to the institution.
2. The mode best suited for preparing and executing the budget.
3. The form that best serves the needs for financial reporting.
4. The presentation that will improve the quality of comparative studies among institutions.

Thus, expenditures and transfers may be classified in terms of programs, functions, organizational units, projects, and object classes.

Classifications by *program* often cut across organizational, functional, and even fund group lines and are useful in the planning processes. The *functional* classification pattern—educational and general, auxiliary enterprises, hospitals, independent operations, and their subcategories—provides the greatest comparability of data among institutions. The classification by *organizational units* provides data corresponding to channels of intra-institutional administrative responsibilities. Classification by *projects* serves to provide data corresponding to the pattern in which gifts, grants, and contracts are utilized by the institution. Classification by *object class*—that is, according to materials or capital assets purchased or services received, such as personal services, staff benefits, printing and stationery, travel, communications, food, fuel, utilities, repairs, equipment, and library books—serves internal management needs.

Published financial reports usually classify expenditures and transfers in terms of function, organizational unit, and object, in that order.

It is suggested that the following functional classification be followed:

Educational and General
  Expenditures
    Instruction
    Research
    Public Service
    Academic Support
    Student Services
    Institutional Support
    Operation and Maintenance of Plant
    Scholarships and Fellowships
  Mandatory Transfers
  Nonmandatory Transfers
Auxiliary Enterprises
  Expenditures
  Mandatory Transfers
  Nonmandatory Transfers
Hospitals
  Expenditures
  Mandatory Transfers
  Nonmandatory Transfers
Independent Operations
  Expenditures
  Mandatory Transfers
  Nonmandatory Transfers

Educational and General

Instruction. This category should include expenditures for all activities that are part of an institution's instruction program, with the exception of expenditures for remedial and tutorial instruction, which should be categorized as Student Services. Expenditures for credit and noncredit courses, for academic, occupational, and vocational instruction, and for regular, special, and extension sessions should be included.

Expenditures for departmental research and public service that are not separately budgeted should be included in this classification. This category excludes expenditures for academic administration when the primary assignment is administration—for example, academic deans. However, expenditures for department chairmen, in which instruction is still an important role of the administrator, are included in this category.

Research. This category should include all expenditures for activities specifically organized to produce research outcomes, whether commissioned by an agency external to the institution or separately budgeted by an organizational unit within the institution. Subject to these conditions, it includes expenditures for individual and/or project research as well as those of institutes and research centers. This category does not include all sponsored programs (training grants are an example) nor is it necessarily limited to sponsored research, since internally supported research programs, if separately budgeted, might be included in this category under the circumstances described above. Expenditures for departmental research that are separately budgeted specifically for research are included in this category.

Public Service. This category should include funds expended for activities that are established primarily to provide noninstructional services beneficial to individuals and groups external to the institution. These activities include community service programs (excluding instructional activities) and cooperative extension services. Included in this category are conferences, institutes, general advisory services, reference bureaus, radio and television, consulting, and similar noninstructional services to particular sectors of the community.

Academic Support. This category should include funds expended primarily to provide support services for the institution's primary missions—instruction, research, and public service. It includes (1) the retention, preservation, and display of educational materials—for example, libraries, museums, and galleries; (2) the provision of services that directly assist the academic functions of the institution, such as demonstration schools associated with a department, school, or college of education; (3) media, such as audiovisual services and technology such as computing support; (4) academic administration (including academic deans but not department chairmen) and personnel development providing administrative support and management direction to the three primary missions; and (5) separately budgeted support for course and curriculum development. For institutions that currently charge certain of the expenditures—for example, computing support—directly to the various operating units of the institution, such expenditures are not reflected in this category.

Student Services. This category should include funds expended for offices of admissions and registrar and those activities whose primary purpose is to contribute to the student's emotional and physical well-being and to his intellectual, cultural, and social development outside the context of the formal instruction program. It includes expenditures for student activities, cultural events, student newspaper, intramural athletics, student organizations, intercollegiate athletics (if the program is operated as an integral part of the department of physical education and not as an essentially self-supporting activity), supplemental educational services to provide matriculated students with supplemental instruction outside of the normal academic program (remedial instruction is an example), counseling and career guidance (excluding informal academic counseling by the faculty), student aid administration, and student health service (if not operated as an essentially self-supporting activity).

Institutional Support. This category should include expenditures for: (1) central executive-level activities concerned with management and long-range planning of the entire institution, such as the governing board, planning and programming, and legal services; (2) fiscal operations, including the investment office; (3) administrative data processing; (4) space management; (5) employee personnel and records; (6) logistical activities that provide procurement, storerooms, safety, security, printing, and transportation services to the institution; (7) support services to faculty and staff that are not operated as auxiliary enterprises; and (8) activities concerned with community and alumni relations, including development and fund raising.

Appropriate allocations of institutional support should be made to auxiliary enterprises, hospitals, and any other activities not reported under the Educational and General heading of expenditures.

Operation and Maintenance of Plant. This category should include all expenditures of current operating funds for the operation and maintenance of physical plant, in all cases net of amounts charged to auxiliary enterprises, hospitals, and independent operations. It does not include expenditures made from the institutional plant fund accounts. It includes all expenditures for operations established to provide services and maintenance related to grounds and facilities. Also included are utilities, fire protection, property insurance, and similar items.

Scholarships and Fellowships. This category should include expenditures for scholarships and fellowships in the form of outright grants to students selected by the institution and financed from current funds, restricted or unrestricted. It also should include trainee stipends, prizes, and awards, except trainee stipends awarded to individuals who are not enrolled in formal course work, which should be charged to instruction, research, or public service as appropriate. If the institution is given custody of the funds, but is not allowed to select the recipient of the grant—for example, federal Basic Educational Opportunity Grants program or ROTC scholarships—the funds should be reported in the Agency Funds group rather than in the Current Funds group. The recipient of an outright grant is not required to perform service to the institution as consideration for the grant, nor is he expected to repay the amount of the grant to the funding source. When services are required in exchange for financial assistance, as in the federal College Work-Study Program, the charges should be classified as expenditures of the department or organizational unit to which the service is rendered. Aid to students in the form of tuition or fee remissions also should be included in this category. However, remissions of tuition or fees granted because of faculty or staff status, or family relationship of students to faculty or staff, should be recorded as staff benefit expenditures in the appropriate functional expenditure category.

Mandatory Transfers. This category should include transfers from the Current Funds group to other fund groups arising out of (1) binding legal agreements related to the financing of educational plant, such as amounts for debt retirement, interest, and required provisions for renewals and replacements of plant, not financed from other sources, and (2) grant agreements with agencies of the federal government, donors, and other organizations to match gifts and grants to loan and other funds. Mandatory transfers may be required to be made from either unrestricted or restricted current funds.

Nonmandatory Transfers. This category should include those transfers from the Current Funds group to other fund groups made at the discretion of the governing board to serve a variety of objectives, such as additions to loan funds, additions to quasi-endowment funds, general or specific plant additions, voluntary renewals and replacements of plant, and prepayments on debt principal. It also may include the retransfer of resources back to current funds.

Auxiliary Enterprises

An auxiliary enterprise is an entity that exists to furnish goods or services to students, faculty, or staff, and that charges a fee directly related to, although not necessarily equal to, the cost of the goods or services. The distinguishing characteristic of auxiliary enterprises is that they are managed as essentially self-supporting activities. Examples are residence halls, food services, intercollegiate athletics, (only if essentially self-supporting), college stores, faculty clubs, faculty and staff parking, and faculty housing. Student health services, when operated as an auxiliary enterprise, also should be included. The general public may be served incidentally by auxiliary enterprises. Hospitals, although they may serve students, faculty, or staff, are separately classified because of their relative financial significance.

This category includes all expenditures and transfers relating to the operation of auxiliary enterprises, including expenditures for operation and maintenance of plant and for institutional support; also included are other direct and indirect costs, whether charged directly as expenditures or allocated as a proportionate share of costs of other departments or units.

Expenditures. Expenditures of auxiliary enterprises are identified by using the same general criteria as for educational and general expenditures to distinguish them from transfers.

Mandatory Transfers. This type of transfer follows the same criteria of identification as for educational and general mandatory transfers to distinguish them from expenditures and nonmandatory transfers.

Nonmandatory Transfers. This type of transfer follows the same criteria of identification as for educational and general nonmandatory transfers to distinguish them from expenditures and mandatory transfers.

Hospitals

This category includes all expenditures and transfers associated with the patient care operations of the hospital, including nursing and other professional services, general services, administrative services, fiscal services, and charges for physical plant operations and institutional support. Also included are other direct and indirect costs, whether charged directly as expenditures or allocated as a proportionate share of costs of other departments or units. Expenditures for those activities which take place within the hospital, but which are categorized more appropriately as instruction or research, should be excluded from this category and accounted for in the appropriate categories.

Expenditures. The same criteria for identifying expenditures are used as in the case of educational and general expenditures to distinguish them from transfers.

Mandatory Transfers. The same criteria for identifying mandatory transfers are used as in the case of educational and general mandatory transfers to distinguish them from expenditures and nonmandatory transfers.

Nonmandatory Tranfers. The same criteria for identifying nonmandatory transfers are used as in the case of educational and general nonmandatory transfers to distinguish them from expenditures and mandatory transfers.

Independent Operations

This category includes expenditures and transfers of those operations which are independent of, or unrelated to, but which may enhance the primary missions of the institution. This category generally is limited to expenditures associated with major federally funded research laboratories. This category excludes expenditures associated with property owned and managed as investments of the institution's endowment funds.

Expenditures. The same criteria for identifying expenditures are used as in the case of educational and general expenditures to distinguish them from transfers.

Mandatory Transfers. The same criteria for identifying mandatory transfers are used as in the case of educational and general mandatory transfers to distinguish them from expenditures and nonmandatory transfers.

Nonmandatory Transfers. The same criteria for identifying nonmandatory transfers are used as in the case of educational and general nonmandatory transfers to distinguish them from expenditures and mandatory transfers.

Deductions from Fund Balances

The term "deductions" is in contrast to expenditures and transfers. Deductions represent decreases in current fund balances, such as refunds to donors and grantors, and unencumbered or unexpended funds returned or returnable to the state treasury at fiscal year-end, depending on provisions of state statutes or appropriation acts.

.11 ILLUSTRATIVE EXHIBITS*

[Chapter 5: 7]

THE FIGURES used in the accompanying exhibits are illustrative only and are not intended to indicate any relationship among accounts. The summary of significant accounting policies and notes to financial statements relate to the illustrative statements. Modifications should be made thereto as appropriate to actual circumstances.

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* From *College and University Business Administration,* third edition (Washington, D.C., 1974), by permission of the National Association of College and University Business Officers.

Sample Educational Institution

Balance

June 30,

with comparative figures

Assets

Current Funds

	Current Year	Prior Year
Unrestricted		
Cash	$ 210,000	$ 110,000
Investments	450,000	360,000
Accounts receivable, less allowance of $18,000 both years	228,000	175,000
Inventories, at lower of cost (first-in, first-out basis) or market	90,000	80,000
Prepaid expenses and deferred charges	28,000	20,000
Total unrestricted	1,006,000	745,000
Restricted		
Cash	145,000	101,000
Investments	175,000	165,000
Accounts receivable, less allowance of $8,000 both years	68,000	160,000
Unbilled charges	72,000	——
Total restricted	460,000	426,000
Total current funds	1,466,000	1,171,000

Loan Funds

	Current Year	Prior Year
Cash	30,000	20,000
Investments	100,000	100,000
Loans to students, faculty, and staff, less allowance of $10,000 current year and $9,000 prior year	550,000	382,000
Due from unrestricted funds	3,000	——
Total loan funds	683,000	502,000

Endowment and Similar Funds

	Current Year	Prior Year
Cash	100,000	101,000
Investments	13,900,000	11,800,000
Total endowment and similar funds	14,000,000	11,901,000

Exhibit 1

Sheet

19____

at June 30, 19____

Liabilities and Fund Balances

Current Funds

	Current Year	Prior Year
Unrestricted		
Accounts payable	$ 125,000	$ 100,000
Accrued liabilities	20,000	15,000
Students' deposits	30,000	35,000
Due to other funds	158,000	120,000
Deferred credits	30,000	20,000
Fund balance	643,000	455,000
Total unrestricted	1,006,000	745,000
Restricted		
Accounts payable	14,000	5,000
Fund balances	446,000	421,000
Total restricted	460,000	426,000
Total current funds	1,466,000	1,171,000

Loan Funds

	Current Year	Prior Year
Fund balances		
U.S. government grants refundable	50,000	33,000
University funds		
Restricted	483,000	369,000
Unrestricted	150,000	100,000
Total loan funds	683,000	502,000

Endowment and Similar Funds

	Current Year	Prior Year
Fund balances		
Endowment	7,800,000	6,740,000
Term endowment	3,840,000	3,420,000
Quasi-endowment—unrestricted	1,000,000	800,000
Quasi-endowment—restricted	1,360,000	941,000
Total endowment and similar funds	14,000,000	11,901,000

Exhibit I—Continued

Annuity and Life Income Funds		
Annuity funds		
Cash	$ 55,000	$ 45,000
Investments	3,260,000	3,010,000
Total annuity funds	3,315,000	3,055,000
Life income funds		
Cash	15,000	15,000
Investments	2,045,000	1,740,000
Total life income funds	2,060,000	1,755,000
Total annuity and life income funds	5,375,000	4,810,000
Plant Funds		
Unexpended		
Cash	275,000	410,000
Investments	1,285,000	1,590,000
Due from unrestricted current funds	150,000	120,000
Total unexpended	1,710,000	2,120,000
Renewals and replacements		
Cash	5,000	4,000
Investments	150,000	286,000
Deposits with trustees	100,000	90,000
Due from unrestricted current funds	5,000	—
Total renewals and replacements	260,000	380,000
Retirement of indebtedness		
Cash	50,000	40,000
Deposits with trustees	250,000	253,000
Total retirement of indebtedness	300,000	293,000
Investment in plant		
Land	500,000	500,000
Land improvements	1,000,000	1,110,000
Buildings	25,000,000	24,060,000
Equipment	15,000,000	14,200,000
Library books	100,000	80,000
Total investment in plant	41,600,000	39,950,000
Total plant funds	43,870,000	42,743,000
Agency Funds		
Cash	50,000	70,000
Investments	60,000	20,000
Total agency funds	110,000	90,000

See accompanying Summary of Significant Accounting

Annuity and Life Income Funds		
Annuity funds		
Annuities payable	$ 2,150,000	$ 2,300,000
Fund balances	1,165,000	755,000
Total annuity funds	3,315,000	3,055,000
Life income funds		
Income payable	5,000	5,000
Fund balances	2,055,000	1,750,000
Total life income funds	2,060,000	1,755,000
Total annuity and life income funds	5,375,000	4,810,000
Plant Funds		
Unexpended		
Accounts payable	10,000	—
Notes payable	100,000	—
Bonds payable	400,000	—
Fund balances		
Restricted	1,000,000	1,860,000
Unrestricted	200,000	260,000
Total unexpended	1,710,000	2,120,000
Renewals and replacements		
Fund balances		
Restricted	25,000	180,000
Unrestricted	235,000	200,000
Total renewals and replacements	260,000	380,000
Retirement of indebtedness		
Fund balances		
Restricted	185,000	125,000
Unrestricted	115,000	168,000
Total retirement of indebtedness	300,000	293,000
Investment in plant		
Notes payable	790,000	810,000
Bonds payable	2,200,000	2,400,000
Mortgages payable	400,000	200,000
Net investment in plant	38,210,000	36,540,000
Total investment in plant	41,600,000	39,950,000
Total plant funds	43,870,000	42,743,000
Agency Funds		
Deposits held in custody for others	110,000	90,000
Total agency funds	110,000	90,000

Policies and Notes to Financial Statements

Sample Educational Institution

Statement of Changes in

Year Ended June 30,

	Current Funds	
	Unrestricted	Restricted
Revenues and other additions		
Unrestricted current fund revenues	$7,540,000	
Expired term endowment—restricted		
State appropriations—restricted		
Federal grants and contracts—restricted		500,000
Private gifts, grants, and contracts—restricted		370,000
Investment income—restricted		224,000
Realized gains on investments—unrestricted		
Realized gains on investments—restricted		
Interest on loans receivable		
U.S. government advances		
Expended for plant facilities (including $100,000 charged to current funds expenditures)		
Retirement of indebtedness		
Accrued interest on sale of bonds		
Matured annuity and life income restricted to endowment		
Total revenues and other additions	7,540,000	1,094,000
Expenditures and other deductions		
Educational and general expenditures	4,400,000	1,014,000
Auxiliary enterprises expenditures	1,830,000	
Indirect costs recovered		35,000
Refunded to grantors		20,000
Loan cancellations and write-offs		
Administrative and collection costs		
Adjustment of actuarial liability for annuities payable		
Expended for plant facilities (including noncapitalized expenditures of $50,000)		
Retirement of indebtedness		
Interest on indebtedness		
Disposal of plant facilities		
Expired term endowments ($40,000 unrestricted, $50,000 restricted to plant)		
Matured annuity and life income funds restricted to endowment		
Total expenditures and other deductions	6,230,000	1,069,000

Exhibit 2

Fund Balances

19____

			Plant Funds			
Loan Funds	Endowment and Similar Funds	Annuity and Life Income Funds	Unexpended	Renewals and Replacements	Retirement of Indebtedness	Investment in Plant
			50,000			
			50,000			
100,000	1,500,000	800,000	115,000		65,000	15,000
12,000	10,000		5,000	5,000	5,000	
	109,000					
4,000	50,000		10,000	5,000	5,000	
7,000						
18,000						
						1,550,000
						220,000
					3,000	
	10,000					
141,000	1,679,000	800,000	230,000	10,000	78,000	1,785,000
10,000						
1,000						
1,000					1,000	
		75,000				
			1,200,000	300,000		
					220,000	
					190,000	
						115,000
	90,000					
		10,000				
12,000	90,000	85,000	1,200,000	300,000	411,000	115,000

Exhibit 2—Continued

Transfers among funds—additions/(deductions)	**Current Funds** **Unrestricted**	**Current Funds** **Restricted**
Mandatory:		
Principal and interest	(340,000)	
Renewals and replacements	(170,000)	
Loan fund matching grant	(2,000)	
Unrestricted gifts allocated	(650,000)	
Portion of unrestricted quasi-endowment funds investment gains appropriated	40,000	
Total transfers	(1,122,000)	
Net increase/(decrease) for the year	188,000	25,000
Fund balance at beginning of year	455,000	421,000
Fund balance at end of year	643,000	446,000

See accompanying Summary of Significant Accounting

			Plant Funds			
Loan Funds	Endowment and Similar Funds	Annuity and Life Income Funds	Unexpended	Renewals and Replacements	Retirement of Indebtedness	Investment in Plant
					340,000	
				170,000		
2,000						
50,000	550,000		50,000			
	(40,000)					
52,000	510,000		50,000	170,000	340,000	
181,000	2,099,000	715,000	(920,000)	(120,000)	7,000	1,670,000
502,000	11,901,000	2,505,000	2,120,000	380,000	293,000	36,540,000
683,000	14,000,000	3,220,000	1,200,000	260,000	300,000	38,210,000

Policies and Notes to Financial Statements

Sample Educational Institution

Statement of Current Funds Revenues,

Year Ended June

Revenues

Tuition and fees	
Federal appropriations	
State appropriations	
Local appropriations	
Federal grants and contracts	
State grants and contracts	
Local grants and contracts	
Private gifts, grants, and contracts	
Endowment income	
Sales and services of educational departments	
Sales and services of auxiliary enterprises	
Expired term endowment	
Other sources (if any)	
Total current revenues	

Expenditures and mandatory transfers

Educational and general	
Instruction	
Research	
Public service	
Academic support	
Student services	
Institutional support	
Operation and maintenance of plant	
Scholarships and fellowships	
Educational and general expenditures	
Mandatory transfers for:	
Principal and interest	
Renewals and replacements	
Loan fund matching grant	
Total educational and general	

Exhibit 3

Expenditures, and Other Changes

30, 19____

Current Year			
Unrestricted	Restricted	Total	Prior Year Total
$2,600,000		$2,600,000	$2,300,000
500,000		500,000	500,000
700,000		700,000	700,000
100,000		100,000	100,000
20,000	$ 375,000	395,000	350,000
10,000	25,000	35,000	200,000
5,000	25,000	30,000	45,000
850,000	380,000	1,230,000	1,190,000
325,000	209,000	534,000	500,000
190,000		190,000	195,000
2,200,000		2,200,000	2,100,000
40,000		40,000	
7,540,000	1,014,000	8,554,000	8,180,000
2,960,000	489,000	3,449,000	3,300,000
100,000	400,000	500,000	650,000
130,000	25,000	155,000	175,000
250,000		250,000	225,000
200,000		200,000	195,000
450,000		450,000	445,000
220,000		220,000	200,000
90,000	100,000	190,000	180,000
4,400,000	1,014,000	5,414,000	5,370,000
90,000		90,000	50,000
100,000		100,000	80,000
2,000		2,000	
4,592,000	1,014,000	5,606,000	5,500,000

Exhibit 3—Continued

Expenditures and mandatory transfers

Auxiliary enterprises
Expenditures ....
Mandatory transfers for:
Principal and interest..........
Renewals and replacements..........
Total auxiliary enterprises..........
Total expenditures and mandatory transfers..........

Other transfers and additions/(deductions)

Excess of restricted receipts over transfers to revenues..........
Refunded to grantors..........
Unrestricted gifts allocated to other funds..........
Portion of quasi-endowment gains appropriated..........
Net increase in fund balances..........

See accompanying Summary of Significant

Current Year			Prior
Unrestricted	Restricted	Total	Year Total
1,830,000		1,830,000	1,730,000
250,000		250,000	250,000
70,000		70,000	70,000
2,150,000		2,150,000	2,050,000
6,742,000	1,014,000	7,756,000	7,550,000
	45,000	45,000	40,000
	(20,000)	(20,000)	
(650,000)		(650,000)	(510,000)
40,000		40,000	
188,000	25,000	213,000	160,000

Accounting Policies and Notes to Financial Statements

SAMPLE EDUCATIONAL INSTITUTION
SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

June 30, 19——

The significant accounting policies followed by Sample Educational Institution are described below to enhance the usefulness of the financial statements to the reader.

Accrual Basis

The financial statements of Sample Educational Institution have been prepared on the accrual basis except for depreciation accounting as explained in notes 1 and 2 to the financial statements. The statement of current funds revenues, expenditures, and other changes is a statement of financial activities of current funds related to the current reporting period. It does not purport to present the results of operations or the net income or loss for the period as would a statement of income or a statement of revenues and expenses.

To the extent that current funds are used to finance plant assets, the amounts so provided are accounted for as (1) expenditures, in the case of normal replacement of movable equipment and library books; (2) mandatory transfers, in the case of required provisions for debt amortization and interest and equipment renewal and replacement; and (3) transfers of a nonmandatory nature for all other cases.

Fund Accounting

In order to ensure observance of limitations and restrictions placed on the use of the resources available to the Institution, the accounts of the Institution are maintained in accordance with the principles of "fund accounting." This is the procedure by which resources for various purposes are classified for accounting and reporting purposes into funds that are in accordance with activities or objectives specified. Separate accounts are maintained for each fund; however, in the accompanying financial statements, funds that have similar characteristics have been combined into fund groups. Accordingly, all financial transactions have been recorded and reported by fund group.

Within each fund group, fund balances restricted by outside sources are so indicated and are distinguished from unrestricted funds allocated to specific purposes by action of the governing board. Externally restricted funds may only be utilized in accordance with the purposes established by the source of such funds and are in contrast with unrestricted funds over which the governing board retains full control to use in achieving any of its institutional purposes.

Endowment funds are subject to the restrictions of gift instruments requiring in perpetuity that the principal be invested and the income only be utilized. Term endowment funds are similar to endowment funds except that upon the passage of a stated period of time or the occurrence of a particular event, all or part of the principal may be expended. While quasi-endowment funds have been established by the governing board for the same purposes as endowment funds, any portion of quasi-endowment funds may be expended.

All gains and loses arising from the sale, collection, or other disposition of investments and other noncash assets are accounted for in the fund which owned such assets. Ordinary income derived from investments, receivables, and the like is accounted for in the fund owning such assets, except for income derived from investments of endowment and similar funds, which income is accounted for in the fund to which it is restricted or, if unrestricted, as revenues in unrestricted current funds.

All other unrestricted revenue is accounted for in the unrestricted current fund. Restricted gifts, grants, appropriations, endowment income, and other restricted resources are accounted for in the appropriate restricted funds. Restricted current funds are reported as revenues and expenditures when expended for current operating purposes.

Other Significant Accounting Policies

Other significant accounting policies are set forth in the financial statements and the notes thereto.

SAMPLE EDUCATIONAL INSTITUTION
NOTES TO FINANCIAL STATEMENTS

June 30, 19——

1. Investments exclusive of physical plant are recorded at

cost; investments received by gifts are carried at market value at the date of acquisition. Quoted market values of investments (all marketable securities) of the funds indicated were as follows:

	Current year	*Prior year*
Unrestricted current funds	$ 510,000	$ 390,000
Restricted current funds	180,000	165,000
Loan funds	105,000	105,000
Unexpended plant funds	1,287,000	1,600,000
Renewal and replacement funds	145,000	285,000
Agency funds	60,000	20,000

Investments of endowment and similar funds and annuity and life income funds are composed of the following:

	Carrying value	
	Current year	*Prior year*
Endowment and similar funds:		
Corporate stocks and bonds (approximate market, current year $15,000,000, prior year $10,900,000)	$13,000,000	$10,901,000
Rental properties—less accumulated depreciation, current year $500,000, prior year $400,000	900,000	899,000
	13,900,000	11,800,000
Annuity funds:		
U.S. bonds (approximate market, current year $200,000, prior year $100,000)	200,000	110,000
Corporate stocks and bonds (approximate market, current year $3,070,000, prior year $2,905,000)	3,060,000	2,900,000
	3,260,000	3,010,000
Life income funds:		
Municipal bonds (approximate market, current year $1,400,000, prior year $1,340,000)	1,500,000	1,300,000

Corporate stocks and bonds (approximate market, current year $650,000, prior year $400,000)	545,000	440,000
	2,045,000	1,740,000

Assets of endowment funds, except nonmarketable investments of term endowment having a book value of $200,000 and quasi-endowment having a book value of $800,000, are pooled on a market value basis, with each individual fund subscribing to or disposing of units on the basis of the value per unit at market value at the beginning of the calendar quarter within which the transaction takes place. Of the total units each having a market value of $15.00, 600,000 units were owned by endowment, 280,000 units by term endowment, and 120,000 units by quasi-endowment at June 30, 19——

The following tabulation summarizes changes in relationships between cost and market values of the pooled assets:

	Pooled Assets		*Net Gains (Losses)*	*Market Value per Unit*
	Market	*Cost*		
End of year ..	$15,000,000	$13,000,000	$2,000,000	$15.00
Beginning of year	10,900,000	10,901,000	(1,000)	12.70
Unrealized net gains for year ...			2,001,000	
Realized net gains for year ...			159,000	
Total net gains for year ...			$2,160,000	2.30

The average annual earnings per unit, exclusive of net gains, were $.56 for the year.

2. Physical plant and equipment are stated at cost at date of acquisition or fair value at date of donation in the case of gifts, except land acquired prior to 1940, which is valued at appraisal value in 1940 at $300,000. Depreciation on physical plant and equipment is not recorded.

3. Long-term debt includes: bonds payable due in annual installments varying from \$45,000 to \$55,000 with interest at $5\frac{7}{8}\%$, the final installment being due in 19. . . ., collateralized by trust indenture covering land, buildings, and equipment known as Smith dormitory carried in the accounts at \$2,500,000, and pledged net revenue from the operations of said dormitory; and mortgages payable due in varying amounts to 19. . . . with interest at 6%, collateralized by property carried in the accounts at \$800,000 and pledged revenue of the Student Union amounting to approximately \$65,000 per year.

4. The Institution has certain contributory pension plans for academic and nonacademic personnel. Total pension expense for the year was \$350,000, which includes amortization of prior service cost over a period of 20 years. The Institution's policy is to fund pension costs accrued, including periodic funding of prior years' accruals not previously funded. The actuarially computed value of vested benefits as of June 30, 19..... exceeded net assets of the pension fund by approximately \$300,000.

5. Contracts have been let for the construction of additional classroom buildings in the amount of \$3,000,000. Construction and equipment are estimated to aggregate \$5,000,000, which will be financed by available resources and an issue of bonds payable over a period of 40 years amounting to \$4,000,000.

6. All interfund borrowings have been made from unrestricted funds. The amounts due to plant funds from current unrestricted funds are payable within one year without interest. The amount due to loan funds from current unrestricted funds is payable currently.

7. Pledges totaling \$260,000, restricted to plant fund uses, are due to be collected over the next three fiscal years in the amounts of \$120,000, \$80,000, and \$60,000, respectively. It is not practicable to estimate the net realizable value of such pledges.

.12 CHART OF ACCOUNTS*

[Chapter 5: 6]

A SYSTEMATIC CLASSIFICATION of accounts is an essential part of an accounting system. The accounts should be developed to be compatible with the organizational structure of the institution, and their form and content should be arranged in agreement with the financial reports to be presented.

The arrangement should be formalized in a chart of accounts, and for ease of identification and reference, each account should be assigned an appropriate code number or symbol. Classification should be according to the funds and fund groups of the institution, as described in the preceding chapters of Part 5. Within each fund group, the accounts should be listed according to assets, liabilities, and fund balance accounts.

The illustrative chart of accounts for a college or university presented below shows those accounts usually found in the general ledger or carried in subsidiary ledgers with appropriate control accounts in the general ledger. This chart is presented as a guide for institutions in developing their own detailed charts of accounts and to help them set up their accounts in conformity with the principles of accounting and reporting presented in the preceding chapters of Part 5. The system of accounts may be expanded, contracted, or modified to meet the needs of the individual institution and to conform to its organizational structure, but in any case it should incorporate the basic elements common to all educational institutions.

In designing or revising a chart of accounts, the code numbers or symbols assigned to the accounts should progress in a logical order. Because each fund and fund group is carried in the accounting records as a separately balanced group, the accounts in any given group should be assigned a code number that, perhaps by a prefix, identifies that fund group—for example, all accounts related to current funds should be identifiable as such; all accounts for plant funds should be identifiable as such. Similarly, within the fund groups, consistent code numbers should identify subgroups, assets, liabilities, and fund balances. For revenue accounts, code numbers or symbols can be used to identify sources.

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* From *College and University Business Administration,* third edition (Washington, D.C., 1974), by permission of the National Association of College and University Business Officers.

For expenditure accounts, code numbers or symbols can be used to identify functions, organizational units, projects, programs, and objects of expenditures. The individual fund identity should be an integral part of the fund balance, revenue, and expenditure account codes.

In developing a chart of accounts, it is important to exercise economy in the use of digits and characters for code numbers, to plan a logical arrangement for the chart, and to make ample provision for future expansion of account numbers.

GENERAL LEDGER ACCOUNTS

Current Funds—Unrestricted

Asset Accounts

- Cash
- Petty Cash
- Investments
- Accounts Receivable—*detailed as needed, for example:*
  - Students
  - Hospital Patients
  - Governmental
  - Unbilled Charges
- Notes Receivable—*detailed as needed*
  - Allowance for Doubtful Accounts and Notes—*credit balance account associated with each type of receivable*
- Inventories—*detailed as needed, for example:*
  - College Store
  - Dining Halls
  - Central Stores
  - Plant Operation and Maintenance Supply Store
- Prepaid Items and Deferred Charges—*detailed as needed*
- Due from Other Fund Groups

Liability and Fund Balance Accounts

- Notes Payable
- Accounts Payable and Accrued Expenses—*detailed as needed*
- Deferred Credits
- Deposits
- Due to Other Fund Groups
- Fund Balances—Allocated—*detailed as needed, for example:*
  - Auxiliary Enterprises
  - Reserve for Encumbrances
  - Reserve for Computer Use Survey
  - Reserve for Faculty Self-Improvement Program
- Fund Balance—Unallocated

Operating Accounts. The following control accounts in the general ledger for actual revenues, expenditures, and other changes are supported in detail by Current Funds Revenues and Current Funds Expenditures *and Other Changes accounts in subsidiary ledgers. If desired, several control accounts may be provided in lieu of single control accounts:*

Revenues Control—*credit account*

Expenditures and Other Changes Control—*debit account*

When budgetary accounts are carried in the general ledger, the following control accounts would appear in the chart of accounts. They are supported in detail by Current Funds Revenues and Current Funds Expenditures and Other Changes accounts in subsidiary ledgers:

Estimated Revenues *or* Unrealized Revenues

Expenditures and Other Changes Allocations *or* Budget Allocations for Expenditures and Other Changes

Unallocated Budget Balance *or* Unassigned Budget Balance

Current Funds—Restricted

These accounts are to be used if the assets and liabilities of such funds are separated from those of Unrestricted Current Funds.

Asset Accounts

Cash

Investments

Accounts Receivable—*detailed as needed, for example*:

- Governmental
- Other
- Unbilled Charges

Allowance for Doubtful Accounts—*credit balance account*

Due from Other Fund Groups

Liability and Fund Balance Accounts

Accounts Payable

Due to Other Fund Groups

Fund Balances—Allocated—*detailed as needed, for example:*

- Reserve for Encumbrances
- Auxiliary Enterprises

Fund Balances—Unallocated

Both of the fund balance accounts may be control accounts supported by separate subsidiary ledger accounts for each restricted current fund and for each type of fund balance. Additional control accounts may be provided as required or desired.

Operating Accounts. Expenditures of restricted current funds may be recorded in the operating accounts of unrestricted current funds, in which case transfers of restricted current funds to current funds revenues accounts would be made to finance such expenditures. When this is not done, operating accounts for each current restricted fund must provide for proper classification of expenditures by object, as well as providing for appropriate categorization of sources of additions, deductions other than expenditures, and transfers to and from other funds.

Loan Funds

Asset Accounts

Cash
Investments
Notes Receivable from Students, Faculty, and Staff
  Allowance for Doubtful Loans—*credit balance account*

Liability and Fund Balance Accounts

Accounts Payable to Collection Agencies
Due to Other Fund Groups
Refunds Payable on Refundable Government Grants
Fund Balances—*This may be a control account supported by separate subsidiary ledger accounts for each fund. Separate accounts should be carried to identify the sources of funds available for loans, such as donor- and government-restricted loan funds, including funds provided by mandatory transfers required for matching purposes, unrestricted funds designated as loan funds, and funds returnable to the donor under certain conditions. Accounts to identify allocations of fund balances should be provided. Accounts may be maintained to identify resources available for loans to students separately from those for faculty and staff.*

Endowment and Similar Funds

Asset Accounts

Cash
Accounts Receivable
Notes Receivable
  Allowance for Doubtful Accounts and Notes—*credit balance account*
Prepaid Items
Investments—*detailed as needed, for example:*
  Bonds
    Allowance for Unamortized Bond Premiums
    Allowance for Unamortized Bond Discounts
  Preferred Stocks
  Common Stocks
  Mortgage Notes
  Real Estate
    Allowance for Depreciation—*credit balance account*
Due from Other Fund Groups

Liability and Fund Balance Accounts

The fund balance accounts should be classified as to Endowment, Term Endowment, and Quasi-Endowment Funds, even though the investments of the funds may be merged in one or more investment pools.
Payables—*detailed as needed, for example:*
  Mortgages Payable
  Notes Payable
  Accounts Payable
Collateral Due on Securities Loaned
Due to Other Fund Groups

Balances of Endowment Funds
Balances of Term Endowment Funds
Balances of Quasi-Endowment Funds—Unrestricted
Balances of Quasi-Endowment Funds—Restricted
In order to differentiate between the balances of funds for which the income is unrestricted and those for which the income is restricted, the following accounts may be employed:
Balances of Endowment Funds—Unrestricted
Balances of Endowment Funds—Restricted—*detailed as needed, for example:*
Professorships
Instructional Departments
Scholarships
Library
Loan Funds

Note. The balances of term endowment funds also may be identified in this manner.

Undistributed Gains and Losses on Investment Transactions—*Separate accounts should be established for each investment pool.*
Undistributed Share Adjustments—*Separate accounts should be established for each investment pool.*

Annuity and Life Income Funds

If the funds in this section are pooled for investment purposes, accounts for the assets may be classified as shown below for each investment pool. If any funds are separately invested, accounts should be set up for the investment of such funds.

Asset Accounts

Cash
Accounts Receivable
Notes Receivable
Allowance for Doubtful Accounts and Notes—*credit balance account*
Investments—*detailed as needed, for example:*
Bonds
Allowance for Unamortized Bond Premiums
Allowance for Unamortized Bond Discounts
Preferred Stocks
Common Stocks
Mortgage Notes
Real Estate
Allowance for Depreciation—*credit balance account*
Due from Other Fund Groups

Liability and Fund Balance Accounts

Accounts Payable
Annuity Payments Currently Due
Annuities Payable
Life Income Payments Currently Due
Due to Other Funds for Advances on Annuity Payments

Due to Other Funds for Advances to Income Beneficiaries
Undistributed Income—Annuity Funds
Undistributed Income—Life Income Funds
Balances of Annuity Funds
Balances of Life Income Funds

These may be control accounts supported by subsidiary ledger accounts for each fund. Within the two categories the accounts may be listed alphabetically by name, or they may be classified in any other manner at the discretion of the institution.

Undistributed Gains and Losses on Investment Transactions—*Separate accounts should be established for each investment pool.*

Undistributed Share Adjustments—*Separate accounts should be established for each investment pool.*

Income, Expenditure, and Transfer Accounts

Income from Investments—*credit account, detailed by each agreement*

Expenditures and Transfers—*debit account, detailed by each agreement*

Plant Funds—Unexpended

Asset Accounts

Cash
Investments
Receivables—*detailed as needed*
  Allowance for Doubtful Accounts—*credit balance account*
Due from Other Fund Groups
Construction in Progress—*alternatively can be shown in Investment in Plant subgroup of Plant Funds*

Liability and Fund Balance Accounts

Accounts Payable
Notes Payable
Bonds Payable
Mortgages Payable
Due to Other Fund Groups
Fund Balances—*This may be a control account supported by subsidiary ledger accounts which should differentiate between unrestricted and restricted funds.*

Plant Funds—Funds for Renewals and Replacements

These accounts should be used if the assets of such funds are separated from the assets of other subgroups of Plant Funds.

Asset Accounts

Cash
Accounts Receivable
  Allowance for Doubtful Accounts—*credit balance account*
Investments
Deposits with Trustees
Due from Other Fund Groups

Liability and Fund Balance Accounts

Accounts Payable
Due to Other Fund Groups
Fund Balances—*This may be a control account supported by subsidiary ledger accounts which should differentiate between unrestricted and restricted funds.*

Plant Funds—Funds for Retirement of Indebtedness

These accounts should be used if the assets of such funds are separated from the assets of other subgroups of Plant Funds.

Asset Accounts

Cash
Accounts and Notes Receivable
  Allowance for Doubtful Accounts—*credit balance account*
Investments
Deposits with Trustees
Due from Other Fund Groups

Liability and Fund Balance Accounts

Accounts Payable
Due to Other Fund Groups
Fund Balances—*This may be a control account supported by subsidiary ledger accounts which should differentiate between unrestricted and restricted funds.*

Plant Funds—Investment in Plant

Asset Accounts

Land
Buildings
  Allowance for Depreciation—*credit balance account*
Improvements Other than Buildings
  Allowance for Depreciation—*credit balance account*
Equipment
  Allowance for Depreciation—*credit balance account*
Library Books
Art Museums and Collections
Construction in Progress—*alternatively can be shown in the Unexpended Plant Funds subgroup of Plant Funds*

Liability and Fund Balance Accounts

Accounts Payable
Notes Payable
Bonds Payable
Mortgages Payable
Leaseholds Payable
Due to Other Fund Groups
Net Investment in Plant —*detailed as needed*

Agency Funds

Asset Accounts

Cash
Accounts Receivable
Notes Receivable
Allowance for Doubtful Accounts and Notes—*credit balance account*
Investments
Due from Other Fund Groups

Liability Accounts

Accounts Payable
Due to Other Fund Groups
Deposit Liabilities—*Accounts for each agency fund should be carried either in the general ledger or in subsidiary ledgers.*

CURRENT FUNDS REVENUES ACCOUNTS
(Separate Restricted and Unrestricted Accounts)

Tuition and Fees—*detailed as needed*

Federal Appropriations

State Appropriations

Local Appropriations

Federal Grants and Contracts

State Grants and Contracts

Local Grants and Contracts

Private Gifts, Grants, and Contracts—*detailed as needed*

Endowment Income—*detailed as needed, for example:*
Income from Funds Held by Others Under Irrevocable Trusts

Sales and Services of Educational Activities—*detailed as needed, for example:*

Film Rentals
Testing Services
Home Economics Cafeteria
Demonstration Schools
Dairy Creameries
Food Technology Divisions

Sales and Services of Auxiliary Enterprises—*detailed as needed, for example:*

Residence Halls
Faculty Housing
Food Services
College Union
Additional revenue accounts may be established for sources of sales, types of products and services, and cash and interdepartmental sales.

Sales and Services of Hospitals—*detailed as needed, for example:*

Daily Patient Services
Nursing Services
Other Professional Services
Health Clinics *if an integral part of the hospital*

Other Sources—*detailed as needed*

Independent Operations—*detailed as needed by organizational units*

CURRENT FUNDS EXPENDITURES AND TRANSFERS ACCOUNTS

Current funds expenditures accounts should bear identifying codes and symbols that will identify functions, such as Instruction, Institutional Support, and Scholarships and Fellowships; identify organizational units, such as Department of Physics, Controller's Office, and Registrar's Office; and identify the object of expenditures, such as Personnel Compensation, Supplies and Expenses, and Capital Expenditures. If desired, interdepartmental purchases, as contrasted with purchases from external sources, also may be identified by code or symbol. The object coding and symbols should be designed to provide for common usage of the objects throughout the entire chart of accounts, although, of course, there will be individual object codings that will be used only for particular functional categories.

Educational and General

Instruction

Accounts by divisions, schools, colleges, and departments of instruction following the administrative organization of the institution. The four functional subcategories are:

General academic instruction
Occupational and vocational instruction
Special session instruction
Community education

Research

Accounts by individual projects, classified by organizational units. The two functional subcategories are:

Institutes and research centers
Individual or project research

Public Service

Accounts by activities, classified by type of activity, such as:

Community Service
Conferences and Institutes
Cooperative Extension Service
Public Lectures
Radio
Television

Academic Support

Accounts by activities, classified by type of activity, such as:

Academic Administration and Personnel Development
Audiovisual Services
Computing Support *(excluding administrative data processing), unless distributed to using activites*
Course and Curriculum Development
Demonstration Schools
Libraries
Museums and Galleries

Student Services

Accounts by activities, classified by type of activity, such as:

Admissions Office
Counseling and Career Guidance
Cultural Events
Dean of Students
Financial Aid Administration
Health and Infirmary Services *if not an integral part of a hospital nor operated as an essentially self-supporting operation*
Intramural Athletics
Intercollegiate Athletics *if operated as an integral part of department of physical education and not essentially self-supporting*
Registrar
Student Organizations
Remedial Instruction

Institutional Support—*detailed as needed, for example:*

Governing Board
Chief Executive Office
Chief Academic Office
Chief Business Office
Investment Office
Legal Counsel
Administrative Data Processing

Alumni Office
Auditing, internal and external
Safety
Security
Catalogues and Bulletins
Commencements
Convocations
Development Office
Employee Personnel and Records
Fund Raising
General Insurance *other than Property Insurance*
Interest on Current Funds Loans
Legal Fees
Memberships
Printing
Provisions for Doubtful Accounts and Notes
Publications
Public Relations
Purchasing
Service Departments
There should be interim accounts for all organizational units classified in this category; these accounts should be closed out at the end of each fiscal year.
Space Management
Telephone and Telegraph *unless charged to departmental budgets*
Transportation *including motor pool, unless operated as a service department*

Operation and Maintenance of Plant

Accounts for all organizational units and functions, such as:
Administration
Custodial Services
Maintenance of Buildings
Maintenance of Grounds
Utilities
Trucking Services
Fire Protection
Property Insurance

Scholarships and Fellowships

Accounts as needed and desired for scholarships, fellowships, grants-in-aid, trainee stipends, prizes, and awards.
Tuition and Fee Remissions *unless properly classified as staff benefit expenditures*
Accounts may be set up for instructional divisions and departments, such as:
School of Medicine
Department of Physics

Mandatory Transfers, Educational and General—*detailed to show subcategories, such as:*

Provision for Debt Service on Educational Plant
Loan Fund Matching Grants

Nonmandatory Transfers, Educational and General *(to and from)*—*detailed to show significant subcategories, such as:*

Loan Funds
Quasi-Endowment Funds
Appreciation on Securities of Endowment and Similar Funds
Plant Funds
  Renewals and Replacements of Plant Assets
  Additions to Plant Assets
  Voluntary Payments on Debt Principal

Auxiliary Enterprises, Hospitals, and Independent Operations

Auxiliary Enterprises

Accounts as needed and desired for such enterprises as included in the Current Funds Revenues accounts.
Provision should be made for identification of manadatory and nonmandatory transfers—to and from—by significant subcategories.

Hospitals

Accounts as needed and desired. Provision should be made for identification of mandatory and nonmandatory transfers—to and from—by significant subcategories.

Independent Operations

Accounts as needed and desired for organizational units.
Provision should be made for identification of mandatory and nonmandatory transfers—to and from—by significant subcategories.

CLASSIFICATION OF EXPENDITURES BY OBJECT

The object classification of expenditures identifies that which is received in return for the expenditures. Object classification has importance as a tool for internal management, but should be considered complementary to the classification of expenditures by function and organizational unit and should not replace these classifications in the various schedules of current funds expenditures. The value of object classification will depend on the usefulness of the information it provides to management. The classifications may be omitted from published financial reports or they may be used to any degree considered desirable by the institution. The use of object classifications and the related identifying codes and symbols should not be carried to an extreme; the number of categories should be limited to those that will be of significant value to management.

Three major object classifications are found in most colleges and universities: Personnel Compensation, Supplies and Expenses, and Capital Expenditures. Breakdowns of objects within these major categories may be necessary or desirable in some situations.

Personnel Compensation

This classification includes salaries, wages, and staff benefits. In the various salary and wage expense accounts, it may be desirable to distinguish between groups of faculty and other staff members, such as full-time and part-time personnel; student and nonstudent workers; and professional, secretarial, clerical, skilled, and nonskilled employees. Appropriate code numbers and symbols within this category will aid in identifying, collecting, and summarizing information.

Supplies and Expenses

Because of their general significance to nearly all organizational units within an institution, it may be beneficial to identify significant categories of these expenditures, such as supplies, telephones, travel, and contractual services.

Capital Expenditures

The following object categories within this classification (which includes both additions to and renewals and replacements of capital assets) may prove helpful in the accounting and reporting systems of educational institutions: scientific equipment, laboratory apparatus, office machines and equipment, library books, furniture and furnishings, motor vehicles, machinery and tools, building remodeling, minor construction, and livestock.

Section 10,030

Statement of Position 74-11 Financial Accounting and Reporting by Face-Amount Certificate Companies

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Section 10,030

Statement of Position 74-11 Financial Accounting and Reporting by Face-Amount Certificate Companies

[Proposal to Financial Accounting Standards Board to Amend AICPA Industry Audit Guide on Audits of Investment Companies with Respect to Face-Amount Certificate Companies]

AICPA **American Institute of Certified Public Accountants**
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

December 10, 1974

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Proposal to Amend
AICPA Industry Audit Guide on
Audits of Investment Companies
With Respect to
Face-Amount Certificate Companies

Dear Mr. Armstrong:

The accompanying Statement of Position, prepared by the Accounting Standards Task Force on Investment Companies, proposes amendments to the AICPA Industry Audit Guide on Audits of Investment Companies which would exclude face-amount certificate companies from the general definition of investment companies set forth in the Guide. Accordingly, these companies (there are four in active operation at the present time) would not be required to follow the accounting provisions of the Guide.

While issuance of this Statement of Position will be helpful to independent auditors, we urge that FASB advise the accounting profession at an early date as to whether it believes the proposed amendments are appropriate and should be regarded as having the same authoritative support as the Audit Guide itself.

Members of the Task Force will be glad to meet with you or your representatives to discuss this proposal. The Task Force would also appreciate being advised as to the Board's proposed action on its recommendations.

Sincerely yours,

ACCOUNTING STANDARDS TASK FORCE ON INVESTMENT COMPANIES

James H. Muller, Chairman
Charles Adams
Philip L. Cohen
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NOTES

The American Institute of Certified Public Accountants has issued a series of industry-oriented Audit Guides that present recommendations on auditing procedures and auditors' reports and in some instances on accounting principles, and a series of Accounting Guides that present recommendations on accounting principles. Based on experience in the application of these Guides, AICPA Task Forces may from time to time conclude that it is desirable to change a Guide. A Statement of Position is used to revise or clarify certain of the recommendations in the Guide to which it relates. A Statement of Position represents the considered judgment of the responsible AICPA Task Force.

To the extent that a Statement of Position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the Audit Guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the Task Force.

To the extent that a Statement of Position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the Task Force are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the Task Force believes would be in the public interest.

FINANCIAL ACCOUNTING AND REPORTING BY FACE-AMOUNT CERTIFICATE COMPANIES

BACKGROUND INFORMATION

.01 The AICPA Industry Audit Guide sets forth the following general definition of the investment company industry:

> "The business of an investment company consists of selling its capital shares to the public, investing the proceeds—for the most part in securities—in a manner seeking to achieve its announced investment objectives, and distributing to its shareholders the net income from, and the net gains realized on sales of, its investments. Generally, an investment company can be said to be a pooling of funds by shareholders to avail themselves of professional investment management." [1]

[1] AICPA, *Audits of Investment Companies*, (New York: 1973), p. 1.

.02 The Guide then includes face-amount certificate companies as investment companies to which the Guide is applicable by the following:

> "Within the umbrella of the above general definition fall many forms of investment companies, including management investment companies, *face-amount certificate companies* (emphasis supplied), unit investment trusts, collective trust funds, investment partnerships, and 'offshore funds'." [2]

.03 In its Glossary, the Guide defines a face-amount certificate as "A security representing an obligation of the issuer to pay a stated amount at a fixed date in the future, the consideration for which is either payment of periodic installments of a stated amount or a single lump payment." A face-amount certificate company is "An investment company engaged in the business of issuing face-amount certificates of the installment type." [3]

.04 The task force has reconsidered the appropriateness of including face-amount certificate companies in the definition of "investment companies" included in the Guide.

RECOMMENDATION

.05 The Task Force believes that face-amount certificate companies do not fall within the general definition of investment companies set forth in the Guide and, therefore, such companies should not be required to follow the accounting provisions of the Guide.

.06 Specifically, the Task Force believes that *Audits of Investment Companies* should be amended as follows:

(a) The phrase "face-amount certificate companies," should be deleted from the first sentence of the second paragraph on page 1 of the Guide.

(b) The definition of a face-amount certificate company on page 141 of the Guide should be changed to read, "A company (not an "investment company" as defined elsewhere herein, but subject to the provisions of the Investment Company Act of 1940) engaged in the business of issuing face-amount certificates of the installment type."

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[2] *Ibid.*
[3] *Ibid.*, p. 141.

REASONS FOR RECOMMENDATIONS

.07 The Guide's definition of an investment company quoted earlier in this Statement of Position is not met by face-amount certificate companies for the following reasons:

(a) The business of a face-amount certificate company does not consist of "selling its capital shares to the public." Such companies (there are only four in active operation at the present time) are in the business of selling certificates which are fixed obligations and liabilities of the company.

(b) A face-amount certificate company does not distribute to its certificate holders "the net income from, and the net gains realized on sales of, its investments."

(c) A face-amount certificate company does not pool funds obtained from its shareholders. It pools the funds obtained from its certificate holders with the hope that the investments made will both satisfy the company's obligations to those certificate holders and result in a profit for shareholder(s).

.08 Because of these essential differences between face-amount certificate companies and investment companies, which were not recognized in the Guide, it is not appropriate to define face-amount certificate companies as a type of investment company for the purposes of the Guide and, therefore, such companies should not be required to follow the accounting provisions of the Guide.

Section 10,040

Statement of Position 74-12 Accounting Practices in the Mortgage Banking Industry

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Section 10,040

Statement of Position 74-12
Accounting Practices in the Mortgage Banking Industry

[Recommendation to Financial Accounting Standards Board]

AICPA

American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

December 30, 1974

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying Statement of Position presents recommendations of the Accounting Standards Division on Accounting Practices in the Mortgage Banking Industry. It was prepared on behalf of the Division by the Accounting Standards Executive Committee for consideration by the Financial Accounting Standards Board and for such action as the Board deems appropriate.

The Statement takes the position that a mortgage banker's loan portfolio (other than loans held for long-term investment) should be valued using the lower of cost or market method. A mortgage banker will occasionally hold mortgage loans for long-term investment, and in those situations the cost method of valuing such loans is found to be appropriate. The Statement recommends procedures to be followed in determining the lower of cost or market in various circumstances and offers guidance for identifying those mortgage loans which are long-term investments.

With respect to transactions between affiliates, the Statement notes that, except in rare circumstances, generally accepted accounting principles require the postponement of profit until sale to unrelated third parties. Consequently, it takes the position that sales of mortgages to an affiliate by a mortgage banker should, in most cases, be recorded at the lower of cost or market value at the date a management decision has been reached that a sale between affiliates will occur.

The Statement indicates that both classified and unclassified balance sheets are acceptable, but recommends that mortgages held for sale and mortgages held for investment should be distinguished in any balance sheet.

The Division would appreciate being advised as to the Board's proposed action on the recommendations set forth in this Statement of Position.

Sincerely yours,

Stanley J. Scott (ral)
STANLEY J. SCOTT
Chairman
Accounting Standards Division

NOTES

Statements of Position of the Accounting Standards Division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of Statements of Position is to influence the development of accounting and reporting standards in directions the Division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, Statements of Position do not establish standards enforceable under the Institute's Code of Professional Ethics.

ACCOUNTING PRACTICES IN THE MORTGAGE BANKING INDUSTRY

INTRODUCTION

.01 The Accounting Standards Division of the American Institute of Certified Public Accountants has reviewed certain accounting practices used by mortgage bankers in accounting for their inventory of permanent mortgage loans held for sale and in preparing their balance sheets. This review indicated that two accounting methods are widely used in accounting for such loans held for sale, the cost method and the lower of cost or market method. The review also indicated that practices vary in measuring the lower of cost or market and in recording transactions with affiliates. Both classified and nonclassified balance sheets were also noted.

.02 In recent years, accountants, investors and other users of financial statements have expressed concern over the acceptability of alternative accounting methods in accounting for similar business transactions. The Division believes that it is not desirable to have alternative methods and measurement practices acceptable for accounting for mortgage loans held for sale by mortgage bankers. Therefore, the Division is expressing in this Statement its position on a preferable accounting method and on preferable measurement practices for such mortgage loans.

.03 The Division's position as set forth herein applies to financial statements of mortgage bankers which purport to present financial position, changes in financial position, or results of operations in conformity with generally accepted accounting principles.

.04 The key terms in this Statement are defined in the Glossary. Excerpts from accounting literature relating to each Division position are also included in an Appendix.

THE MORTGAGE BANKING INDUSTRY

.05 Mortgage bankers, an important part of the real estate industry, by bringing potential borrowers and investors together, originate, market and service real estate mortgage loans. Other mortgage banking operations, including insurance, property management, real estate development and sales, management of real estate investment trusts and joint venture investments are subsidiary or collateral to the fulfillment of this primary role. While some mortgage bankers trace their ancestry to real estate firms operating prior to 1900, the real impetus to mortgage banking occurred in the 1930s with the advent of the insurance of residential mortgages by the Federal Housing Administration. The existence of government insurance enhanced the salability of such loans to financial institutions, particularly in capital-rich areas. Both by law and custom, the geographically distant permanent investor needed a local representative to collect payments, make periodic property inspections, and make certain that insurance and property tax payments were kept current by mortgagors. After World War II, residential loans guaranteed by the Veterans Administration became an important source of loan origination and servicing operations for mortgage bankers. In recent years, mortgage bankers have also originated a significant volume of non-insured residential loans and of income property mortgages, including loans on shopping centers, office buildings and multi-family apartment complexes. A considerable number of these income property or commercial loans are originated for sale on a servicing-released basis, with the servicing performed by the investor. However, most servicing of residential loans and a very significant portion of the servicing of commercial loans is still performed by the mortgage banker for a fee based on a percent of the outstanding principal balance of the loan.

.06 Mortgage bankers acquire mortgage loans for sale to permanent investors from a variety of sources. Among these sources are applications directly from borrowers, purchases from realtors and brokers, purchases from investors and conversions of various forms of interim financing, such as construction loans, to permanent financing. Residential loans guaranteed or insured by the Federal Housing Administration or the Veterans Administration have usually been acquired at a discount from par, due to the submarket interest rate of such loans. Non-Federally guaranteed or conventional residential mortgages are also often acquired at a discount from par. Commercial loans are generally acquired at par. Current industry practice, with which the Division agrees, is to defer recording any purchase discounts as income until final placement of the loans with the permanent investor.

.07 The mortgage banker sells the mortgages he originates to a variety of permanent investors, including savings and loan associations, mutual savings banks, insurance companies, pension funds, the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association. Since 1970, many mortgages have also been placed in trusts to collateralize Mortgage Backed Securities issued by mortgage bankers and guaranteed by the Government National Mortgage Association. Mortgage banker activities thus primarily consist of two separate but interrelated operations: the origination and marketing of real estate mortgages, and the subsequent long-term servicing of such loans.

.08 Most mortgage bankers originate and service two types of loans, residential and income or commercial. While the servicing procedures are somewhat similar for the two loan types, the origination operations are significantly different and almost always require separate organizations, procedures, and decisions. Residential loans are usually obtained directly from borrowers referred to the mortgage banker by real estate brokers or builders. Since the amount of any one loan is relatively small, the mortgage banker will often originate residential loans without specific commitments from a permanent investor to purchase the loans. If the mortgage banker has any commitment to cover such loans it will normally be a block commitment for a large dollar volume of residential loans meeting broad general criteria.

.09 Income or commercial loan origination procedures differ significantly from residential loan originations. Some of the more common commercial loan origination procedures are:

(a) Normally, the mortgage banker does not issue a commitment to the borrower without first obtaining an investor's commitment to purchase the specific loan.

(b) Each borrower's loan application is matched to an investor's commitment rather than packaging several loans to one commitment.

(c) A single commercial loan representative may deal with both the borrower and the investor.

(d) Each loan is usually large in amount and requires careful appraisal, analysis, and packaging for an investor commitment.

(e) Most loans, upon borrower acceptance of the permanent loan commitment, are not funded for several months until construction of the project is completed.

.10 After originating a mortgage loan the mortgage banker normally must hold the loan for a period ranging from 60 to 180 days, during which time processing of documentation is completed and marketing efforts are made. During the processing period the loans are usually pledged as collateral for the short-term bank loans (the "warehouse line") used to finance the purchase and ownership of the mortgages. During the holding period the mortgage banker must assume the primary risk for the collectibility of the loan, fluctuations in carrying costs due to changes in short-term interest rates, and fluctuations in the final sales price of the loan due to changes in long-term interest rates. These risks may be partly reduced through government guarantees or through the purchase from permanent investors of commitments to buy loans at stated prices and under stated conditions, as described in paragraphs .08 and .09.

BASIS OF VALUATION OF MORTGAGE LOANS OWNED

Current Industry Practice

.11 Mortgage bankers have traditionally been short-term brokers of mortgage loans, acquiring such loans from third parties, processing and marketing them, and selling them to permanent investors. The mortgage banker has typically not become an investor himself because of a desire to avoid competing with his investors and because mortgage bankers generally have had limited equity and long-term funds. However, mortgage loans held for sale, because of the 60 to 180 day processing period, usually constitute the largest asset owned by a mortgage banker.

.12 Practices with regard to risks assumed by mortgage bankers during the processing and marketing phase of their operating cycle have varied. Some mortgage bankers have avoided assuming any risk by purchasing commitments from investors to cover loans as they are acquired, and thus only in rare circumstances could these mortgage bankers suffer a marketing loss. Other companies have elected to rely on their marketing efforts to avoid a loss on the sale of their loans, and even hopefully to generate a profit, and consequently have not acquired commitments for any of their loans. Most companies, of course, fall between these two extremes, obtaining specific commitments for commercial loans and block commitments for some of their residential loans. Such block commitments, when purchased in advance of loan production, carry some element of risk because changes in acquisition costs may reduce or eliminate the protection afforded by such commitments. Finally, although rare, an investor may fail to honor a commitment, so that the mortgage banker assumes some risk even with fully committed loans.

.13 The following paragraphs discuss the two valuation methods, "cost" and "lower of cost or market", commonly used by mortgage bankers during the processing and holding period to account for their mortgages owned. These loans, variously labeled "inventory", "loans held for sale to others", "mortgage loans" or "mortgage loans receivable", are classified as current assets by mortgage bankers using classified balance sheets. A majority of mortgage bankers, in terms of asset size and servicing portfolio size, use the lower of cost or market valuation method. A minority of mortgage bankers use the cost valuation method.

Cost Valuation Method

.14 The cost valuation method defers any adjustment for changes in the market value of mortgage loans until completion of the processing and marketing period. Acquired loans are recorded at the principal balance of the loan with any acquisition discounts placed in a purchase discounts account and offset against the related asset on the balance sheet. While industry practice is to record origination fees as income at loan closing, some companies defer recognizing such fees until the loans are sold to investors.

Lower of Cost or Market Valuation Method

.15 The lower of cost or market valuation method recognizes, during the holding period, any decrease in estimated net realizable value below acquisition cost. Specific industry practices with respect to the computation of the lower of cost or market are discussed in detail in paragraphs .22 through .24.

THE DIVISION'S POSITION

Loans Held for Sale

.16 All, or almost all, of the loans owned by a mortgage banker are held for sale during his normal business cycle either as individual loans or as collateral for GNMA securities. Occasionally, some owned loans may be held for longer periods as described in paragraphs .17 through .21. The basic accounting concepts relating to the use of the cost or lower of cost or market methods for valuing loans held for sale are discussed in detail in the accounting literature quoted in paragraphs .44 through .51. The Division finds convincing the rationale advanced for the use of the lower of cost or market valuation method for loans held for sale by mortgage bankers. This conclusion is based on the fact that such a valuation method most clearly represents the economic realities of the mortgage banker's operations. The Division believes that mortgage loans held for sale have characteristics similar to both accounts receivable and finished goods inventory, even though some processing and marketing efforts may still have to be made. Consequently, the accounting principles recommended by the Division are drawn from the principles followed in providing for valuation adjustments for receivables and for reduction of carrying values to the lower of cost or market for inventories. The Division further believes that the computation of market value requires some variation from procedures followed in valuing manufacturing inventories. Such variations are discussed more fully in paragraphs .25 through .32. The Division believes the cost method for valuing loans held for sale fails to reflect economic realities and fails to meet the "conservatism", "accrual", or "measuring of unfavorable event" principles of accounting and, therefore, should not be acceptable.

Loans Held for Market Recovery

.17 The mortgage banker may hold mortgage loans or GNMA securities for extended periods of time if he expects a favorable long-term interest trend. Although these loans may technically not be held for sale during the company's normal operating cycle, the Division believes such loans should also be valued in accordance with the lower of cost or market method prescribed for loans held for sale.

Loans Held for Long-term Investment

.18 The Division finds that accounting practices followed for many years by commercial banks, savings and loan associations, insurance companies and others support the use of the cost method of valuing mortgage loans held as long-term investments. While historically mortgage bankers have not customarily made long-term investments in mortgage loans, the Division recognizes that occasionally such companies may choose to make such investments. The Division considered two areas of concern associated with a mortgage banker's making long-term mortgage loan investments: (1) ways to distinguish between long and short-term investments and (2) the definition of cost.

.19 Determination and verification of a mortgage banker's intent to carry mortgage loans as a long-term investment will always be a difficult judgment. The Division believes that the following conditions, as they existed at the time the investment decision was made, should be considered in verifying a mortgage banker's intent to carry mortgage loans as a long-term investment:

(a) The loans are to be segregated in the accounting records and reports of the company.

(b) There is documentary evidence of a corporate decision to hold such loans to maturity or at least for an extended term.

(c) The loans will be classified as non-current assets if the company's balance sheet is classified.

(d) The mortgage banker has the financial strength to carry such investments for extended periods. Evidence of such financial strength would be an amount of equity and long-term borrowings in excess of the carrying value of such investments. A non-revocable line of credit, effective for the projected holding period from a substantial financial institution would also constitute evidence of substantial financial strength.

.20 The Division believes mortgages transferred into a long-term investment category must be transferred at the lower of cost or market, as defined in paragraphs .25 through .32, at the date of transfer, except that the carrying value of such loans must be further reduced, if necessary, to provide a yield not less than the rate of interest paid on the debt, if any, used to carry the investment. While the transfer to long-term investment will terminate any necessity to write down such loans further in the event of subsequent market declines, the Division also believes it is inappropriate to adjust such loans for any subsequent market recovery. Consequently, so long as a mortgage banker holds loans as long-term investments, such loans should be valued at the lower of cost or market at the date of formal identification as a long-term investment, unless some event occurs indicating a permanent impairment of value, in which case a further reduction in carrying value may be necessary. The Division does believe that, with respect to long-term mortgage loans, any difference between par value of the loans and carrying value as determined above should be amortized and recorded in income. Since mortgage loans are rarely outstanding for their full term, due to prepayments, sales of property etc., the Division believes this amortization may be based on the estimated life of the loans instead of their stated term.

Loans Sold Under Repurchase Agreements

.21 Some mortgage bankers, as a means of financing a portion of their inventory of loans held for sale, temporarily transfer such loans to banks or other financial institutions under repurchase agreements. When the loans are marketed to permanent investors they are reacquired from the banks and sold to the investors. The loans may also be temporarily transferred without a formal repurchase agreement but under circumstances which indicate such an agreement exists on an informal basis; e.g., all marketing efforts are made by the mortgage banker, not the bank; the positive or negative interest spread is the property of the mortgage banker; fluctuations in loan market values are the risk of the mortgage banker; uncollectible loans are reacquired by the mortgage banker; and the mortgage banker routinely reacquires all or almost all of the loans from the bank and resells them to permanent investors. While loans transferred to banks under such "sold loan lines" may technically be sales, the Division believes the existence of a formal repurchase agreement or the existence of evidence of an informal repurchase practice indicates that the risk of market loss is retained by the mortgage banker and such transactions are essentially financing in nature and should be accounted for as such. Therefore, the Division believes the mortgage banker should value all such loans at the lower of cost or market whenever making a loan valuation computation. GNMA certificates sold under repurchase agreements should also be valued at the lower of cost or market.

DEFINITION OF LOWER OF COST OR MARKET

Current Industry Practice

.22 Mortgage bankers generally have two types of loans held for sale: (1) those loans that have been originated specifically to fill existing investor commitments and (2) those loans originated on a speculative or uncommitted basis to fill future investor needs. Mortgages, like other assets, are initially recorded at cost. Cost is generally considered to be the cash or fair value of other assets given in exchange for the asset acquired. While outlays incident to the acquisition as well as the outlay for the asset itself are generally considered to comprise the cost of the asset, the mortgage banking industry generally has not attempted to capitalize the administrative costs involved in the origination of a mortgage. This is due to many factors, including the charging of an origination fee, usually 1% of the mortgage amount, to cover some or all of these origination costs.

.23 Most mortgage bankers have reduced the carrying value of their loans held for sale to market when such market value was less than cost. Generally, such valuation computations are made in the aggregate, either in total or by type of loan, so that any potential losses are reduced by potential gains before a write-down is recorded. However, some companies calculate the write-down on an individual loan basis without offsetting gains against losses. The market values used for comparison are usually those associated with each company's normal investor outlets.

.24 Loans held for sale by mortgage bankers are almost universally financed with short-term bank borrowings collateralized by the mortgages. Normally, long-term mortgage interest rates exceed the short-term rates mortgage bankers pay the banks and a favorable interest spread is an important source of income to the mortgage banker. On occasion, sometimes for extended periods, such short-term rates are higher than long-term rates. This condition not only puts powerful economic pressure on the mortgage banker but also creates an additional problem of valuation. Very few mortgage bankers have considered this "negative interest" factor in their valuation procedures, although some have considered it in their marketing strategy, but if loans are to be held for extended periods, because of market or other conditions, such a factor could become a material problem.

The Division's Position

.25 The Division concludes that the procedures described in paragraphs .26 through .30 should be used in defining the lower of cost or market basis for mortgage loans held for sale.

Computation of Market

.26 Market value of mortgage loans and GNMA Mortgage Backed Securities should be computed by appropriate type of loan with, at a minimum, separate computations made for residential and commercial loans. When calculating the lower of cost or market, either the aggregate or individual loan basis may be used, and the method used should be disclosed in the financial statements. The computation of market is a two tier calculation as follows: first, those loans held subject to existing purchase commitments (committed loans) and, second, those loans held on a speculative basis (uncommitted loans).

Committed Loans and GNMA Securities: Market value for loans and GNMA securities covered by investor commitments should be computed based upon commitment prices. These loans must meet the specific terms of the commitments. Where such loans do not meet the requirements of the commitments, or there exists a reasonable doubt as to acceptance, the loans should be considered uncommitted loans for the calculation of market value.

Uncommitted Loans: Computations of market value for uncommitted loans should be based on the market within which the mortgage banker normally operates. This would include consideration of the following:

(a) Commitments obtained after or shortly before balance sheet date. To the extent such commitments clearly represent market conditions existing at year end, market value computations should be based on these commitment prices.

(b) General indications of market prices and yields sought by the company's normal market outlets.

(c) Quoted GNMA security prices or other public market quotations for long-term mortgage loan rates.

(d) Federal National Mortgage Association Free Market System action prices. Generally all mortgage banking firms are approved seller/servicers of the Federal National Mortgage Association (FNMA) which is the major secondary market source of funds for mortgage bankers. FNMA operates a nationwide mortgage action program called the Free Market System which gives an indication of current market prices for both government and conventional loans via an action system for the purchase of FNMA's commitment to acquire loans from seller/servicers at specific periods of time.

Uncommitted GNMA Mortgage Backed Securities: The mortgage banker may hold GNMA securities in the open market for trading purposes. With respect to the uncommitted securities which are collateralized by his own loans, the current market value of the underlying loans and the current market value of the securities will normally be very similar. If the trust holding the mortgage banker's own loans may be readily terminated and the loans sold directly, the securities may be valued at the lower of cost or market of either the loans or the securities, preferably based on the mortgage banker's sales intent. Other GNMA securities should be valued at the lower of cost or market using the published GNMA securities yield.

Costs Associated with Bulk Purchases: Mortgage bankers sometimes acquire large blocks of existing mortgage loans from investors, including GNMA. Some mortgage bankers have capitalized certain costs associated with these purchases as costs of future servicing income and amortized such costs over the estimated life of the loans. Where such capitalization is appropriate, the costs to be capitalized may be excluded from the cost of the mortgages for the purpose of establishing the lower of cost or market. Where such capitalization is not appropriate, such costs must be considered as part of the cost of the mortgages.

Valuation Dates and Subsequent Changes in Market Conditions

.27 Valuations are to be made at the close of all stockholder reporting periods, including those for interim financial statements. The provisions of APB Opinion No. 28 as to temporary market declines may be applied to such interim financial statements if market conditions have actually improved subsequent to the interim reporting period. Otherwise, market changes subsequent to the valuation date should be considered subsequent period events and, if such changes are material, adequate disclosure should be included in the notes to financial statements as set forth in Sections 560.05 and 560.07 of Statement on Auditing Standards No. 1.

Subsequent Recoveries of Previous Writedowns

.28 The Division believes, as previously noted, that the lower of cost or market valuation procedure for mortgage bankers combines elements of receivable valuation with elements of inventory valuation. Traditionally, inventory valuation concepts have required that, with respect to items which have been written down below cost, the reduced amount is to be considered "cost" for subsequent accounting purposes. Conversely, receivable valuation reserves have often been determined for each reporting period independently, so that receivables are carried at current realizable value. The Division believes it is acceptable for a mortgage banker to calculate the lower of cost or market value at each valuation date independent of any previous calculation. Thus, loans written down in one accounting period (other than those held for long-term investment—see paragraph .20) need not be carried at such reduced value in a later period if their market value has partly or completely recovered.

Excess of Interest Paid Over Interest Received During the Period Mortgages Are Held Pending Sale to Investors

.29 Occasionally, interest paid on warehouse lines exceeds interest received on the underlying mortgage loans. This phenomenon of short-term interest rates exceeding long-term rates is unusual and has occurred infrequently in the past. The Division views the warehousing of mortgages as essentially a financing activity and, accordingly, any negative spread should be charged to current operations as incurred.

Servicing Fee Rates at Other Than Current Market

.30 Occasionally, a mortgage banker will sell or commit to sell loans at a servicing fee rate that is significantly different from rates currently prevalent in the industry. In such cases the loans will generally be sold at prices higher than otherwise available. The result is the recognition of increased income (or reduced loss) at the time of sale offset by reduced servicing income to be recognized in future periods. In other cases a mortgage banker may act as a broker and sell loans with servicing released (no servicing income to be collected nor is the mortgage banker to perform any servicing functions) to either the investor or another servicer. This circumstance is particularly apt to occur with respect to commercial loans, and the mortgage banker may or may not have known and considered the terms of sale at the time the related loans were produced and their acquisition cost was negotiated. In some such cases the loans may be sold at prices higher than otherwise available, in which instance the result would be the recognition of increased income (or reduced loss) at the time of sale but with no servicing income nor related servicing cost in future periods.

.31 The Division concludes that when loans are sold with servicing released, no adjustment of the sales price should be made. However, when loans are sold at a servicing fee rate that is significantly lower than rates currently prevalent in the industry, the Division concludes that an adjustment to the sales price will be required whenever the impact on operating results is significant. Such adjustments would result in deferred credits to be written off into servicing fee income over future years. The amount of any such adjustment and the method of write-off should be determined in such a way that the resulting total of the write-off and actual servicing fee income recognized in each subsequent year from the related loans would approximate the servicing fee income that would have been earned in each subsequent year if the related loans had been sold at a "normal" servicing fee rate. Any such adjustment should be made as of the date the sale of the loans is recorded and any resulting gain or loss is recognized. An adjustment may similarly be required if servicing rates are significantly higher than normal. In determining the market value of mortgage loans held for sale, a similar adjustment should be made to the sales price of any commitment which provides for a servicing fee rate that is lower than rates currently prevalent in the industry.

.32 The Division recognizes that it may be difficult to determine what are "normal" servicing fee rates currently prevalent in the industry. It is necessary that such a determination be made both for the purpose of deciding whether an adjustment is required and for the purpose of quantifying the amount of the adjustment. The Division concludes that a minimum acceptable "normal" servicing fee rate is one that will provide, over the estimated life of the loans, servicing fee income in excess of estimated servicing costs.

ACCOUNTING FOR TRANSACTIONS WITH AFFILIATES

Current Industry Practice

.33 Mortgage banking firms began generally as relatively small, independently owned businesses with nominal equity. They financed their operations, particularly loans held for sale, through bank borrowings collateralized by the related loans. Many mortgage banking firms subsequently were acquired by larger financial institutions. This change was heightened with the expansion of bank holding companies and the inclusion of mortgage banking as a permitted activity by the Board of Governors of the Federal Reserve System. The acquisition of mortgage banking firms resulted in the acquired firms having access to much greater amounts of capital for carrying their mortgage loan inventories and for expansion in construction and development lending.

.34 As many mortgage bankers have become affiliated with banks and other financial institutions the number and magnitude of transactions with related companies have increased. Generally, mortgage loan transactions between affiliated companies have been recorded at the lower of cost or market at the date of transfer. However, some of these transactions have been recorded at original cost, thus not recognizing any marketing losses, since the mortgage banker recovers his basis in the loans and the purchasing affiliate records the loans in its investment account at cost. Occasionally other affiliate transaction techniques have been used, such as purchases at cost using non-interest bearing notes or purchases on a zero-servicing-fee basis. Some mortgage bankers have reported gains or losses on sales of mortgages to their affiliates in the mortgage banker's separate financial statements but have eliminated such gains or losses in the group's consolidated financial statements, while others have reflected such gains and losses on both separate and consolidated financial statements. Transactions with affiliates are a particular problem for mortgage bankers because they must issue separate financial statements.

The Division's Position

.35 APB Opinion No. 18 establishes a number of criteria for determining whether a subsidiary or affiliate relationship exists. These criteria include (a) a presumption of an affiliated relationship if a 20% or greater voting stock ownership exists, either directly or indirectly, and (b) the ability to exercise significant influence over operating and financial policies. The ability to exercise significant influence may be indicated in several ways, such as representation on the board of directors, participation in policy making processes, material intercompany transactions, interchange of managerial personnel, or technological dependency. The Opinion specifically does not apply to investments in nonbusiness entities, such as estates, trusts, and individuals. The Division believes that transactions by mortgage bankers with affiliates, as defined herein, should be accounted for as described in the appropriate sections of paragraphs .36 through .41.

.36 The Division considered accounting for sales of mortgages (other than those held for long-term investment) by a mortgage banker to an affiliated company by recording such sales at (a) the cost basis on the records of the mortgage banker, (b) at the agreed intercompany sales price, or (c) the carrying value (lower of cost or market).

.37 Generally, transactions between affiliated companies should not result in the reporting of gains or losses, as discussed in ARB No. 51, "... any intercompany profit or loss on assets remaining within the group should be eliminated." This principle supports the recording of sales of mortgages to affiliated companies at the mortgage bankers' cost basis. However, particularly when the market value of the mortgages being sold is less than the cost basis, this method tends to disguise the mortgage banker's marketing results. Since the agreed intercompany sales price represents the cash flow reality, support also exists for recording the transaction at this amount. However, for an affiliated group such a sales price may not represent the economic facts and may reflect elements more akin to capital contributions or dividends than to realized gains or losses. The Division, therefore, believes that for transactions with affiliates neither the cost basis nor the agreed sales price basis adequately reflects the nature of the mortgage banker's business.

.38 The Division believes that the separate financial statements of mortgage bankers should reflect the economic conditions within which the mortgage banker operates. In addition, transfers to affiliates are usually similar in nature to transfers to the long-term investment category, and the Division believes both transactions should be accounted for in the same manner. Conversely, however, generally accepted accounting principles require the postponement, except in rare circumstances, of recognition of profits until sale to unrelated third parties. Consequently, the Division believes that sales of mortgages to an affiliate by a mortgage banker should be recorded at the lower of cost or market value as determined at the measurement date, which is the date a management decision has been reached that a sale between affiliates will occur. Although not susceptible of precise definition, determination of the date such a decision is reached should be based upon, at a minimum, formal approval by the appropriate investment authorities of the purchaser, issuance of a binding commitment to purchase the mortgages, and acceptance of the commitment by the selling mortgage banking firm. The amount of any loss should be computed as the difference between market value, calculated in accordance with paragraphs .25 through .32, and the cost of the loans. Since any marketing loss was incurred by the mortgage banker prior to the sale to the affiliate, such loss should not be eliminated in consolidation.

.39 Any amounts paid by an affiliated company in excess of the lower of cost or market value at the measurement date should not be recorded by the mortgage banker as income and any amounts paid which are less than the lower of cost or market value should not be recorded as a loss.

.40 On rare occasions, a mortgage banker may originate a particular class of loans or all loans exclusively for an affiliated company. In such instances the mortgage banker is acting as agent for the affiliate and such loan transfers should be recorded at the mortgage banker's acquisition cost. The Division does not believe, however, that such an agency relationship exists in the case of "right of first refusal" contracts or similar types of agreements or commitments. While the mortgage banker may earn a fee for originating loans as an agent for an affiliated party, the risks, including the marketing risks, associated with ownership of the loans should be borne by the affiliate, not the mortgage banker, for any agency relationship to exist.

.41 In accounting for the sale of mortgages between affiliated companies, there is a presumption that the purchasing company intends to hold purchased mortgages as long-term investments. If repurchase agreements exist (for example, resales of such mortgages by the affiliated purchaser either to the mortgage banking affiliate or to other permanent investors), such presumption may not be sustainable. In this event, consideration should be given to accounting for the transactions as intercompany loans collateralized by the mortgages. In such cases the mortgage banker should continue to value the mortgages as loans held for sale.

CLASSIFICATION OF BALANCE SHEETS

Current Industry Practice

.42 Practices vary within the mortgage banking industry with respect to the preparation of classified or unclassified balance sheets. Historically, government agencies and some investors have requested (but not always required) balance sheets showing current and non-current assets and liabilities. Many mortgage bankers, however, have published non-classified balance sheets in their annual reports, arguing that ordinary working capital ratios are not meaningful tests of mortgage banker financial statements. For most mortgage bankers, a large portion of their short-term liabilities are represented by bank borrowings collateralized by specific mortgage notes receivable. The receivables were purchased using funds obtained from the notes collateralized by the receivables and the notes will be paid off from the funds received from the sale of the receivables. The Mortgage Bankers Association has recently made the following recommendation to the Department of Housing and Urban Development:

"Elimination of References to Current Assets and Liabilities and Net Working Capital in FHA Form 2001-K

"We suggest references to current assets and liabilities and net working capital be deleted from Form 2001-K. Accounting Research Bulletin No. 43, issued by the American Institute of Certified Public Accountants states:

'. . . In the past, definitions of current assets have tended to be overly concerned with whether the asset may be immediately realizable.

'(The current) tendency (is) for creditors to rely more upon the ability of debtors to pay their obligations out of the proceeds of current operations and less upon the debtors' ability to pay in case of liquidation. It should be emphasized that financial statements of a going concern are prepared on the assumption that the company will continue in business.'

"Generally, the existence of a normal operating cycle is the major prerequisite for requiring classification of a company's balance sheet; conversely, where normal operating cycles are not identifiable, the presentation of current asset and liability classifications may not be meaningful. Such is often the case where primarily investing and financing activities are involved. In these cases, due to the direct financing relationship of a substantial portion of total assets to total liabilities, the flow of resources through a normal cycle is unidentifiable. This is also true in very long cycle industries, such as the land development industry. Most mortgage and construction loans of approved mortgagees are not due within one year. In addition, it is reasonable to assume that repayments on loans will generally be used to curtail direct financing activities or be invested in new loans. Also, the general practice of an approved mortgagee is to repay his short-term notes through the specific application of cash received from the sale of his mortgage loan inventory.

"Industry practices for Real Estate Investment Trusts, Banks, Finance Companies and Savings and Loan Associations have eliminated classifications for current assets and liabilities in financial statements. In addition, an increasing number of mortgage banking companies are issuing financial statements without these classifications."

The Division's Position

.43 The Division concurs with the recommendation of the Mortgage Bankers Association to the Department of Housing and Urban Development. However, classified balance sheets are also acceptable. The mortgage banker should distinguish in either type of balance sheet between mortgages held for sale and mortgages held for investment, if any. The notes to the financial statements should disclose to the reader of such financial statements sufficient data to permit the proper evaluation of a company's financial position and results of operations.

APPENDIX A: SURVEY OF ACCOUNTING LITERATURE

Basis of Valuation

.44 The Division found in existing pronouncements of the American Institute of Certified Public Accounts and the Financial Accounting Standards Board no definitive guidance on classifying the balance sheet or valuing the loans held for sale of a mortgage banking company. The Division also examined recent pronouncements on applicable general principles, industry audit guides for related industries, and the suggested chart of accounts and sample financial statements published by the Mortgage Bankers Association for guidance. The following paragraphs summarize the applicable literature.

.45 The concepts of measurement bases and timing of recognition of effects of transactions are discussed in APB Statement No. 4, Paragraph 35. Measurement bases are described as follows: "Several measurement bases are used in financial accounting, for example, net realizable value (receivables), lower of acquisition cost and present market price (inventories), and acquisition cost less accumulated depreciation (plant and equipment). Financial statements in general do not purport to reflect the current value of the assets of the enterprise or their potential proceeds on liquidation under present generally accepted accounting principles." The timing of effects of transactions are described as follows: "The effects of transactions and other events on the assets and liabilities of a business enterprise are recognized and reported in the time periods to which they relate rather than only when cash is received or paid."

.46 Paragraph 160 discusses immediate expense recognition as follows:

> "*Immediate recognition.* Some costs are associated with the current accounting period as expenses because. . . . (2) costs recorded as assets in prior periods no longer provide discernible benefits. . . . The principle of immediate recognition also requires that items carried as assets in prior periods that are discovered to have no discernible future benefits be charged to expense."

Paragraph 171 describes another underlying principle as follows:

> "*Conservatism.* Frequently, assets and liabilities are measured in a context of significant uncertainties. Historically, managers, investors, and accountants have generally preferred that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets. This has led to the convention of conservatism, which is expressed in rules adopted by the profession as a whole such as the rules that inventory should be measured at the lower of cost or market and that accrued net losses should be recognized on firm purchase commitments for goods for inventory. These rules may result in stating net income and net assets at amounts lower than would otherwise result from applying the pervasive measurement principles."

.47 Principles of resource measurement are discussed in APB Statement No. 4, Paragraph 70:

> "Resources are measured in terms of money through money prices, which are ratios at which money and other resources are or may be exchanged. Several types of money prices can be distinguished based on types of markets (purchase prices and sales prices) and based on time (past prices, present prices, and expected future prices). Four types of money prices are used in measuring resources in financial accounting.
>
> 1. *Price in past purchase exchange of the enterprise*
> This price is usually identified as historical cost or acquisition cost because the amount ascribed to the resource is its cost, measured by the money or other resources exchanged by the enterprise to obtain it.
>
> 2. *Price in a current purchase exchange*
> This price is usually identified as replacement cost because the amount ascribed to the resource is measured by the current purchase price of similar resources that would now have to be paid to acquire it if it were not already held or the price that would now have to be paid to replace assets held.
>
> 3. *Price in a current sale exchange*
> This price is usually identified as current selling price because the amount ascribed to the resource is measured by the current selling price of the resource that would be received in a current exchange.
>
> 4. *Price based on future exchanges*
> This price is used in several related concepts—present value of future net money receipts, discounted cash flow, (discounted) net realizable value, and value in use. Each indicates that the amount ascribed to the resource is measured by the expected net future money flow related to the resource in its present or expected use by the enterprise, discounted for an interest factor."

.48 Principles of measuring and recording unfavorable events are discussed in Paragraph 183:

"S-5. *Unfavorable external events other than transfers recorded.* Certain unfavorable external events, other than transfers, that decrease market prices or utility of assets or increase liabilities are recorded."

"M-5. *Measuring unfavorable events.* The amounts of those assets whose decreased market price or utility is recorded are adjusted to the lower market price or recoverable cost resulting from the external event."

"S-5B. *Decline in market price of certain marketable securities.* If market price of marketable securities classified as current assets is less than cost and it is evident that the decline is not due to a temporary condition a loss is recorded when the price declines."

"M-5B. *Measuring losses from decline in price of marketable securities.* The loss on a price decline of marketable securities is measured by the difference between the recorded amount and the lower market price."

"S-5E. *Decline in market prices of noncurrent assets generally not recorded.* Reductions in the market prices of noncurrent assets are generally not recorded until the assets are disposed of or are determined to be worthless."

.49 However, the principle of non-recognition of declines in market prices of non-current assets is modified with respect to long-term investments in the AICPA Statement on Auditing Standards No. 1, Section 332.03: "With respect to the carrying amount of investments, a loss in value which is other than a temporary decline should be recognized in the financial statements of an investor. The independent auditor should, therefore, also examine sufficient competent evidential matter to the extent he deems necessary to determine whether such a loss in value has occurred."

.50 Since mortgage loans held by mortgage bankers have characteristics of both security investments and inventory, and since, while heretofore an extremely rare occurrence, it is possible some mortgage bankers may hold loans for extended periods, the Division further reviewed accounting literature for applicable principles relating to short and long-term investments and inventories.

.51 The AICPA Industry Audit Guide *Audits of Banks,* page 42, describes principles relating to bank security investment (generally bonds, but often mortgages also) as follows: "With relatively few exceptions securities held by banks are of investment grade. If they are held to maturity, they will be redeemed at an amount equal to their amortized cost. Accordingly, it is not customary practice for banks to provide specifically in their accounts for unrealized depreciation in the investment portfolio. This practice appears to be sound. Banks which are dealers in securities, however, should carry their trading account securities, which are in effect inventories, at the lower of cost or market."

Definition of Lower of Cost or Market

.52 Inventory and inventory pricing is discussed in ARB No. 43, Chapter 4, as follows:

> "*Statement 1*—The term *inventory* is used herein to designate the aggregate of those items of tangible personal property which are held for sale in the ordinary course of business."

> "*Statement 5*—A departure from the cost basis of pricing the inventory is required when the utility of the goods is no longer as great as its cost. Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical deterioration, obsolescence, changes in price levels, or other causes, the difference should be recognized as a loss of the current period. This is generally accomplished by stating such goods at a lower level commonly designated as *market*.

> *Discussion*

> "8. Although the cost basis ordinarily achieves the objective of a proper matching of costs and revenues, under certain circumstances costs may not be the amount properly chargeable against the revenues of future periods. A departure from cost is required in these circumstances because cost is satisfactory only if the utility of the goods has not diminished since their acquisition; a loss of utility is to be reflected as a charge against the revenues of the period in which it occurs. Thus, in accounting for inventories, a loss should be recognized whenever the utility of goods is impaired by damage, deterioration, obsolescence, changes in price levels, or other causes. The measurement of such losses is accomplished by applying the rule of pricing inventories at cost or market, whichever is lower. This provides a practical means of measuring utility and thereby determining the amount of the loss to be recognized and accounted for in the current period."

> "*Statement 7*—Depending on the character and composition of the inventory, the rule of cost or market, whichever is lower may properly be applied either directly to each item or to the total of the inventory (or, in some cases, to the total of the components of each

major category). The method should be that which most clearly reflects periodic income.

Discussion

"11. The purpose of reducing inventory to market is to reflect fairly the income of the period. The most common practice is to apply the lower of cost or market rule separately to each item of the inventory. However, if there is only one end-product category the cost utility of the total stock—the inventory in its entirety—may have the greatest significance for accounting purposes. Accordingly, the reduction of individual items to market may not always lead to the most useful result if the utility of the total inventory to the business is not below its cost. This might be the case if selling prices are not affected by temporary or small fluctuations in current costs of purchase or manufacture. Similarly, where more than one major product or operational category exists, the application of the *cost or market, whichever is lower* rule to the total of the items included in such major categories may result in the most useful determination of income.

"12. When no loss of income is expected to take place as a result of a reduction of cost prices of certain goods because others forming components of the same general categories of finished products have a market equally in excess of cost, such components need not be adjusted to market to the extent that they are in balanced quantities. Thus, in such cases, the rule of *cost or market, whichever is lower* may be applied directly to the totals of the entire inventory rather than to the individual inventory items, if they enter into the same category of finished product and if they are in balanced quantities, provided the procedure is applied consistently from year to year."

Accounting for Transactions with Affiliates

.53 The basic accounting theory regarding the appropriate accounting for transactions among affiliated companies was stated in ARB No. 51, Paragraph 1, which states:

"The purpose of consolidated statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions. There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies."

.54 In addition, APB Opinion No. 18 concluded in Paragraph 17:

"The equity method of accounting for an investment in common stock should also be followed by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less of the voting stock. Ability to exercise that influence may be indicated in several ways, such as representation on the board of directors, participation in policy making processes, material intercompany transactions, interchange of managerial personnel, or technological dependency."

.55 The guidelines for consolidation procedure as set forth in ARB No. 51, Paragraph 6, are:

"In the preparation of consolidated statements, intercompany balances and transactions should be eliminated. This includes intercompany open account balances, security holdings, sales and purchases, interest, dividends, etc. As consolidated statements are based on the assumption that they represent the financial position and operating results of a single enterprise, such statements should not include gain or loss on transactions among the companies in the group. Accordingly, any intercompany profit or loss on assets remaining within the group should be eliminated."

.56 The above principle was extended to non-subsidiary investments by Paragraph 19.a of APB Opinion No. 18 as follows:

"Intercompany profits and losses should be eliminated until realized by the investor or investee as if a subsidiary, corporate joint venture or investee company were consolidated."

.57 APPENDIX B: GLOSSARY

Commercial Loans—Loans on income producing property, such as apartments, shopping centers, office buildings and manufacturing facilities.

Commitment Fee—Any fee paid by a potential borrower to a potential lender for the lender's promise to lend money in the future. The issuer may or may not expect to fund the commitment.

Construction Loans—Loans which finance the acquisition of sites for and the construction of residential and income-producing properties. Such loans are usually repaid with the proceeds from the permanent financing.

FNMA—Federal National Mortgage Association—An investor-owned corporation which acts as a secondary market for mortgage loans. Formerly a U.S. Government agency, this corporation frequently performs a counter-cyclical function, supplying funds for the mortgage market when other investor funds are limited and selling mortgages when other investor funds are plentiful.

GNMA—Government National Mortgage Association—A U.S. Government agency which guarantees certain types of mortgage banker debt securities and which funds and administers certain types of low income housing assistance programs.

Loan Commitment—A written promise by a lender to loan a certain sum at a certain rate of interest.

Origination Fee—A fee, normally expressed as a percentage of the principal balance of a loan, charged to compensate the mortgage banker for taking a loan application, obtaining an investor commitment, making property inspections and performing other services related to originating a mortgage loan.

Residential Loans—Loans on one to four family living units.

Servicing Fee—A fee, normally expressed as a percentage of the principal balance of a mortgage loan, charged by a mortgage banker for performing the loan administration functions.

.58

APPENDIX C: APPLICATION OF LOWER OF COST OR MARKET METHOD ON AGGREGATE BASIS TO LOANS HELD FOR SALE

	Stated Loan Interest Rate	Loan Principal Balance	Acquisition Cost	Market Value (A)	Carrying Value
Loan A	9 %	$10,000	$ 9,600	$10,000	
Loan B	8½	10,000	10,000	9,600	
Loan C	9½	10,000	10,500	10,400	
Loan D	8	10,000	9,500	9,200	
Loan E	8	10,000	9,800	9,200	
Loan F	8½	10,000	9,200	9,600	
		$60,000	$58,600	$58,000	$58,000(2)

Note A—Based on long-term interest rate of 9%

COMPUTATIONAL NOTES

(1) Based on an average residential loan life of 12 years, a 1% difference between stated loan interest rate and current

market interest rate equals approximately 8% of loan principal balance.

(2) The carrying value of the loans for a mortgage banker using the identified loan method of applying the lower of cost or market basis would be $57,200, with Loan A valued at its cost, $9,600, and Loan F valued at its cost of $9,200, since unrealized gains are not used to offset unrealized losses in this method.

ACCOUNTING STANDARDS EXECUTIVE COMMITTEE

December 30, 1974

Stanley J. Scott, Chairman	Irving B. Kroll
Hector R. Anton	Raymond C. Lauver
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ACCOUNTING STANDARDS TASK FORCE ON MORTGAGE BANK PORTFOLIOS

December 30, 1974

Alvin Zuckerkorn, Chairman	Joseph Hearne
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	Robert McMullen

Section 10,050

Statement of Position 75-1 Revenue Recognition When Right of Return Exists

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Section 10,050

Statement of Position 75-1 Revenue Recognition When Right of Return Exists

[Recommendation to Financial Accounting Standards Board]

AICPA

American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

January 17, 1975

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying Statement of Position presents recommendations of the Accounting Standards Division on Revenue Recognition When Right of Return Exists. It was prepared on behalf of the Division by the Accounting Standards Executive Committee for consideration by the Financial Accounting Standards Board and for such action as the Board deems appropriate.

As indicated in the introduction, the Statement is intended to apply, broadly speaking, only to situations in which personal property may be returned, whether as a matter of contract or as a matter of existing practice, either by the ultimate consumer or by a party who resells the property to others. Questions have arisen as to the proper accounting in these circumstances and several alternative accounting methods are presently being followed which can produce materially different results.

This Statement takes the position that if a seller is exposed to the risks of ownership through return of the property, the transaction should not be recognized currently as a sale unless all of certain specified conditions are met. One of those conditions is that the amount of future returns can be reasonably predicted. The Statement sets forth factors to be considered in determining whether or not that condition is met.

The Statement also takes the position that if sales are recognized because the specified conditions are met, provision should be made immediately for any costs or losses which may be expected in connection with any returns.

The Division would appreciate being advised as to the Board's proposed action on these recommendations.

Sincerely yours,

Stanley J. Scott

STANLEY J. SCOTT
Chairman
Accounting Standards Division

NOTES

Statements of Position of the Accounting Standards Division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of Statements of Position is to influence the development of accounting and reporting standards in directions the Division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, Statements of Position do not establish standards enforceable under the Institute's Code of Professional Ethics.

REVENUE RECOGNITION WHEN RIGHT OF RETURN EXISTS

INTRODUCTION

.01 This Statement of Position presents recommendations on accounting for revenue in certain sales transactions when the right to return the property exists. It was prepared on behalf of the Accounting Standards Division by the Accounting Standards Executive Committee and represents the conclusions of at least a majority of that Committee.

.02 This Statement of Position applies only to situations in which personal property may be returned, whether as a matter of contract or as a matter of existing practice, either by the ultimate consumer or by a party who resells the property to others. It is not intended to cover accounting for revenue in service industries when part or all of the sales proceeds may be returned under cancellation privileges. In addition, the conclusions expressed herein are not intended to apply to transactions involving real estate or lease arrangements, since such transactions are the subject of AICPA Industry Accounting Guides and Opinions of the Accounting Principles Board.

.03 Situations also exist in which, because of unusual price concessions, sales discounts, collection losses, etc., the economic results of the transaction are substantially the same as if the property were returned. Although transactions of this type are beyond the scope of this Statement, the conclusions in this Statement of Position may be equally appropriate in determining the proper accounting for such transactions. These other transactions are mentioned later in this Statement under "Discussion" and, in Appendix A, under "Selected Examples of Industry Practice."

.04 The Division recognizes that this is only one part of the broad conceptual problem related to the measurement and reporting of revenue. Presumably, that problem will be considered by the FASB when it studies the "fundamentals of accounting and reporting," an element of its project, *Conceptual Framework for Financial Accounting and Reporting.*

.05 This Statement of Position has been prepared and issued because questions have been raised as to the proper accounting when the right of return exists and several alternative accounting methods are presently being followed which can produce materially different results. The Division believes it is necessary and desirable to narrow the available alternatives in this area.

GENERAL BACKGROUND

.06 It is the practice in some industries for customers to be given the right to return goods to the seller under certain circumstances. In the case of sales to the ultimate consumer, the most usual circumstance is that the consumer is dissatisfied with the goods. For sales to customers engaged in the business of reselling the goods, the most usual circumstance is that the customer has not been able to resell the goods to another party. Goods usually can be returned for a full refund of the purchase price, for a credit applied to amounts owed or to be owed for other purchases, or for exchange for other goods.

.07 The right of return can exist either as a matter of contract or as a matter of practice. Such arrangements with customers acquiring for resale are often referred to as "guaranteed sales," and may also be consignments.

.08 Sometimes the returns occur very soon after a sale is made, as in the newspaper and perishable food industries. In other cases a longer time cycle is involved, such as with book publishers and equipment manufacturers. The rate of return varies considerably, from the low percentage of returns usually found in the food industry to the very high rate often found in the publishing industry, where frequently more than half of the items delivered to customers for resale may be returned.

.09 Situations that pose particular problems arise when sales result in significant "overstocking" by customers acquiring goods for resale. In such situations, the recognition of revenue in one period is often followed by substantial returns in a later period.

.10 In practice, accounting for revenue when the right of return exists has varied considerably among companies and among industries. In some cases no sale is recognized until the goods are unconditionally accepted. In other cases a sale is recognized immediately and an allowance for estimated returns is provided. In still other cases a sale is recognized immediately without providing an allowance for returns and, instead, sales returns are recognized at the time returns take place.

THE DIVISION'S CONCLUSIONS

.11 The Division believes that sales transactions should be analyzed to determine their economic substance. If the seller is exposed to the risks of ownership through return of the property, it should be presumed that the transactions should not be recognized currently as sales unless *all* of the following conditions are met (and the usual conditions for recording sales not involving right of return have also been satisfied):

(1) The seller's price to the buyer is substantially fixed or determinable at the date of exchange.

(2) Either the buyer has made full payment, or the buyer is indebted to the seller and payment is not contractually or implicitly excused until such time as the product is resold.

(3) The buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the property.

(4) The buyer acquiring for resale has economic substance apart from that provided by the seller; that is, the buyer is not a straw party or conduit.[1]

---

[1] This condition is concerned primarily with buyers which exist "on paper," i.e., which have little or no physical facilities, employees, etc. It is intended to prevent companies from recognizing sales to parties which the sellers have established primarily for the purpose of recognizing such sales.

(5) The seller does not have significant obligations for future performance to bring about resale of the property by the buyer.

(6) The amount of future returns can be reasonably predicted.

.12 The Division also believes that if sales are recognized because the conditions are met, provision should be made immediately for any costs or losses which may be expected in connection with any returns. Amounts of sales revenue and cost of sales reported in the income statement should exclude the portion for which returns are expected. Transactions for which sales recognition is postponed should be recognized as sales when the return privilege has substantially expired. The seller's gross sales and related accounting policies should be disclosed in the financial statements whenever product returns are a significant factor in the seller's operations.

.13 The ability to make a reasonable prediction of the amount of future returns is dependent on the existence of many factors. While it is not feasible to make an arbitrary determination of when a reasonable prediction can be made, since circumstances vary from one case to the next, the existence of the following factors would appear to impair the ability to make a reasonable prediction:

(1) The susceptibility to significant external factors, such as technological obsolescence or swings in market demand.

(2) Relatively long periods of time before it can be determined that a particular item of property is not returnable.

(3) Absence of historical experience with similar types of sales of similar items of property, or inability to apply such experience because of changing circumstances.

(4) Absence of a large volume of relatively homogeneous transactions.

(5) A significant chance that the selling company's marketing policies and relationships with its customers could change.

.14 Of course, no list can be complete; only general guidelines can be established. Further, the existence of one or more of the above factors may not be sufficiently significant in light of the significance of other factors to prevent making a reasonable prediction.

.15 A reasonable prediction does not require complete knowledge of future events, since it is usually not possible to know with certainty what will occur in the future. It is well established that "Future events and their effects cannot be perceived with certainty."[2] Thus, a reasonable prediction permits some room for doubt.

DISCUSSION

Survey of Accounting Literature

.16 Pervasive revenue recognition principles are set forth in APB Statement No. 4. Paragraph 153 states that "The realization principle requires that revenue be earned before it is recorded." APB Opinion No. 10 states that "revenues should ordinarily be accounted for at the time a transaction is completed, with appropriate provision for uncollectible accounts" but provides for recognizing revenue on the installment or cost recovery methods where there is no reasonable basis for estimating the degree of collectibility of revenue. This concept, and others, are discussed in more detail in the AICPA Industry Accounting Guides, *Accounting for Retail Land Sales, Accounting for Profit Recognition on Sales of Real Estate, Accounting for Motion Picture Films* and *Accounting for Franchise Fee Revenue,* and in FASB Statement No. 13. [As amended, effective January 1, 1977, by FASB Statement No. 13.]

.17 Appendix B presents pertinent quotations from these documents.

The Realization Principle

.18 Accountants have different views as to the realization principle and the point at which revenue should be recognized in income statements. The spectrum of views can be classified as set forth below.

(1) Recognition of increments in value ("holding gains").

[2] APB Opinion No. 20, Paragraph 10.

(2) Recognition of increments in value tied to an event, usually a transaction with outside parties.

(3) Recognition of revenue when there is a transaction with outside parties and the seller has no further obligations or performance requirements.

(4) Recognition of revenue when an unconditional right to receive the consideration of an exchange exists but there is some uncertainty as to the ultimate amount of consideration to be received.

(5) Recognition of revenue only when reasonable assurance exists that the consideration will be received and it is not refundable.

.19 The point at which revenue is recognized in particular circumstances is sometimes resolved based on the availability of objective evidence which can be subjected to audit, on the extent to which additional conditions must be fulfilled or satisfied, or on the relative degree of uncertainty involved. Selection of decision criteria is also dependent upon whether the accounting is for a single transaction or a large volume of similar transactions.

Types of Risks Which Might be Retained by the Seller

.20 The specific problem to which this Statement of Position is addressed is the problem of revenue recognition when the right of return exists. However, it should be noted that a seller might retain the risks of ownership under a variety of arrangements and types of transactions, some of which do not involve the return of the product, as summarized below.

Product Returned

(1) Return if buyer does not resell product.

(2) Return if buyer is dissatisfied with product.

(3) Return under a trade-in privilege, granted to give buyer protection from a decline in the value of the product.

(4) Return resulting from default by buyer on payment of purchase price.

(5) Return resulting from option of buyer to compel seller to repurchase product.

Product Not Returned

(1) Warranties or guarantees as to performance or quality.

(2) Collection losses attributable in whole or in part to losses in collateral value of the product sold.

(3) Price rebates or other concessions.

.21 The risk of loss to which the seller is exposed might be quantitatively the same in any of the above situations. Further, the nature of the risk might be the same regardless of the form of the transaction through which a loss is realized. For example, a significant decline in the market value of the property could result in the return of the property to the seller. In that case, the seller's loss would be equivalent to the loss in market value and perhaps, in addition, costs associated with the return and disposition of the property. If the property is not returned, the seller might nevertheless incur a loss of the same or greater magnitude; for example, in the form of a collection loss.

.22 Risks can be categorized generally between those which are attributable to internal factors, such as manufacturing defects, and those which are attributable to external factors, such as market demand for a product. To a certain extent these factors are closely related. For example, inferior quality can result in low demand for the product. Because of the interrelationship of factors contributing to the risk of loss, it is possible that different types of losses could all be attributable to a single cause. Poor quality manufacturing could result in expenses under warranties, returns of products because of user dissatisfaction, returns of products not resold, losses in the collection of receivables or in the guarantee of buyer financing. Thus, it is reasonably evident that the transaction through which a loss is sustained is not necessarily indicative of the nature of all of the risks to which the seller is exposed or of the cause of the loss.

.23 Frequently, sellers limit their exposure to loss when the product is not returned. For example, limits are placed on warranty coverage, and down payments reduce exposure to credit loss in certain financing arrangements. When a product is returned, however, the exposure to loss may be more significant for a given item of property.

.24 Allowances are generally provided for estimated warranty expenses and estimated losses on the collection of receivables.

Allowances are also often provided to recognize estimated returns. The use of allowances for returns is questionable, however, if the uncertainties and losses are very significant. Instead, it may be necessary to postpone revenue recognition.

.25 The return of property sold is usually a transaction in which the buyer receives either cash, a credit to be applied to amounts owed the seller, or another piece of property. The loss to the seller will be the same in all cases with respect to the return. The seller will have taken back property of lower value (to the seller) than the amount of refund and will incur handling costs and perhaps costs to restore the property to a salable condition.

.26 If there has been an exchange of properties, the loss to the seller can be considered to be reduced by profit attributable to the property issued, particularly if the buyer is obligated to accept property rather than cash or a credit.

Accounting Alternatives

.27 A seller may retain significant risks of ownership if there is a right to return the property. In line with the accounting treatment accorded in certain other situations in which risks are retained, it may not be appropriate to record the transaction as a sale until circumstances assure that the buyer will not return the property. Rationale for this accounting treatment may be summarized as follows:

(1) Realization has not occurred if a "sale" is not an event with economic significance, and other significant economic events must take place in order to provide reasonable assurance that the seller will receive the sales proceeds.

(2) Realization has not occurred if there is a significant chance that events which are beyond the control of the seller, such as rapid technological change or large swings in market demand, could occur that would result in a loss of sales proceeds.

(3) Transactions in which the buyer has an unconditional right of return may be in substance consignments and should be accounted for as such.

(4) Where significant risks of ownership are retained by the seller, objective, verifiable evidence regarding

amounts ultimately to be realized as sales proceeds usually cannot be obtained.

.28 Alternatively, recognition of a sale may be appropriate in many circumstances provided an allowance is established which reduces the amount of sales recorded for estimated returns. Arguments in favor of this accounting approach are summarized as follows:

(1) Financial accounting involves the estimation process in many areas. Without estimates financial statements would be less useful and instead would require numerous judgments to be made by the users of financial statements regarding the economic progress of a business entity when in fact management may well be in a better position to make such judgments.

(2) When a sale takes place, frequently many risks are retained by the seller even if the property will not be returned. For example, the retention of a credit risk often includes the retention of risks of ownership in the property sold. Guarantees of quality also result in retention of some risks of ownership. Provided reasonable estimates can be made, retention of these types of risks generally should not preclude recording sales as deliveries to customers are made.

(3) The delivery of property to a buyer, even though subject to return at a later date, is often a significant economic event which entails agreement by the buyer to accept the property and frequently involves passage of title. Thus, it is an event which has an effect on the cash generating ability of the seller, measurement and reporting of which is considered an important objective of financial statements.

(4) If a loss occurs in a subsequent period which was not reasonably foreseeable, it should be given accounting recognition in the period in which it occurs as an economic consequence of activities of that period. A loss which was not reasonably foreseeable should not preclude recognition of a sale.

.29 The choice between these two accounting alternatives appears to be highly dependent upon the degree to which returns of property can be predicted. If prediction is not possible because of the existence of various factors which are highly uncertain, the second alternative, that of recording the sale together with an allowance for estimated returns, is not a practicable approach. On the other hand, if returns can be reasonably predicted, the alternative of not recording a sale seems to postpone unreasonably an important accounting measurement and fails to give recognition to the portion of sales as to which there is reasonable assurance that the property will not be returned.

.30 A third accounting alternative is to record sales without an allowance for estimated returns and to account for returns as they are received. Arguments for this alternative are the following:

(1) Arguments (3) and (4) for the second alternative above.

(2) Returns are accepted to maintain relationships with customers or market strength, and therefore represent a discretionary period cost similar to advertising.

(3) The effect of returns is often insignificant, especially if another item of property is exchanged and gross profit is not lost.

.31 This accounting alternative is acceptable only if future returns and losses are expected to be clearly insignificant.

APPENDIX A: SELECTED EXAMPLES OF INDUSTRY PRACTICE

.32 These examples are presented in this Appendix only to demonstrate the variety of circumstances and accounting practices that presently exist. This is not an all-inclusive list of those industries in which different accounting alternatives are applied in practice, nor is this Statement of Position intended to be restricted to the industries described herein.

Perishable Foods

.33 Perishable foods, such as bakery products, whether sold to a grocery store, restaurant or institution, are usually sold with the right to return any stale or excess product. For the most part, sales are recorded at the time of delivery with no allowance for returned goods provided. Returns are accounted for as reductions of sales in the period in which the goods are returned. This practice is based on the following industry characteristics:

(1) Orders are based on past experience and knowledge of requirements; the volume of returns is, therefore, not significant in relation to sales.

(2) Some perishable foods, such as stale bakery goods, may be disposed of at discount prices.

.34 To a limited degree, some companies provide allowances for returns when sales are reported. The short time between sale and return permits an easy determination of the amount of allowance.

Rack Jobbers

.35 Retailers often buy merchandise from distributors, known as "rack jobbers," who agree to inspect and restock retailers' shelves periodically with a variety of merchandise, usually within one or more broad classifications, e.g., cosmetics and drugs, records, soft goods. Rack jobbers often provide limited marketing services (for example, determining which brands and quantities should be placed on the retailer's shelves) and thus they act as both buyer and seller. Title usually passes upon delivery, at which time the retailer is billed.

.36 In most cases turnover is fast, with a relatively low rate of return. Sometimes returns are limited to defective merchandise or specifically priced products, both of which might be returned to manufacturers with little or no loss to the rack jobber. In such cases the removal of the product from the retailer's inventory is followed immediately by a replacement with other merchandise. Thus, the gross profit on the initial delivery is not considered to have been lost and an allowance for returns is often not established as it is not considered to be necessary.

.37 Sometimes rack jobbers must accept returns of slow-moving or seasonal merchandise, which may or may not be returned to manufacturers. In some instances allowances for returns are provided; in others, they are not.

Records and Tapes

.38 Record and tape manufacturers generally sell products to distributors with exchange privileges, unlimited right of return, or limited right of return. Rights granted to distributors are usually passed on to the retailers. Payment is usually required within sixty to ninety days. Although inventory held by retailers may be returned to manufacturers, the manufacturers and distributors usually have no information about retailer inventories. However, high volume and relatively stable rates of return have usually enabled companies to record allowances for returns with reasonable accuracy. This practice is followed by the majority of record companies. Rates of return vary according to type of product, but generally fall in the range of 15% to 30%.

Publishing

.39 Sales in the publishing industry are generally made on a fully returnable basis. In some cases, magazine and paperback shipments made to distributors usually produce an excess that will be returned. The fact that demand for publications often cannot be predicted with accuracy, and the fact that the time lag between the sale and return may be from three months to two years or more make the accounting problem more difficult.

Magazine returns from newsstands may be as high as 65%, returns of hard cover books may be as high as 25% and returns of paperback books may be as high as 60%. The distributorship agreement usually provides for advances to be paid to the publisher in installments with the final payment made at the settlement date.

.40 Four methods of recording sales are found in the publishing industry.

(1) Sales are recorded upon shipment and an allowance for returns is established. This practice is generally followed by publishers of paperbacks, hard cover trade books and magazines.

(2) Sales are recorded upon shipment and returns are recorded when they are received. This practice is sometimes used by publishers of hard cover trade and textbooks, where lower rates of return are involved.

(3) Sales are recorded using the consignment method; i.e., sales of those books remaining in the hands of distributors are not recorded. This method is not a common practice.

(4) If a publisher has recently begun operations or has

no relevant experience in the marketing of its new titles, sales are not recorded until the settlement date with the distributor. This is not a common practice.

.41 The allowance for returns is usually established using one of the following methods:

(1) The allowance may be based on historical experience with respect to the percentage of returns over a reasonable period of time. These historical percentages are usually maintained by book title or category of title, or by magazine, and great weight is given to the trend of returns in the last months of the fiscal year. Use of historical data is usually combined with a review of returns actually received and the trend of returns after the balance sheet date.

(2) For new titles, the reserve may be based on management's best estimate if there is sufficient prior experience to judge the success of a new book.

High-Unit-Cost Items

.42 Some manufacturers of certain high-unit-cost products (e.g., mobile homes, trucks, farm machinery, boats) who sell to independent dealers or distributors may be exposed to risks of ownership which may or may not involve return of products.

.43 Financing and other arrangements between the manufacturers and independent dealers vary. In some cases, the manufacturers finance the dealers by providing credit terms that allow the dealers sufficient time to market the product to their customers before paying the manufacturer. The terms under these credit arrangements may or may not require identification of the specific product to be sold prior to remittance to the manufacturers. In other cases, financing is provided to the dealer under "floor plan" financing arrangements either by the manufacturer's captive finance subsidiary or by independent financial institutions. The manufacturer ordinarily guarantees amounts due the financial institutions in the event the dealer is unable to repay amounts borrowed. These financing practices may expose the manufacturer to a potentially significant risk of product returns depending upon other circumstances such as the financial soundness of the dealer and vulnerability of the product to sudden swings in market demand.

.44 Additional existing practices can also influence the selection of an appropriate method of revenue recognition when potential return of a product is involved. For example, contractual arrangements sometimes provide that the manufacturer will grant significant price allowances to dealers for products which remain unsold after a stipulated period of time. In other cases, significant price concessions to dealers may be granted by the manufacturer even though no contractual obligation to do so exists. Another example relates to the variation in economic relationships and contractual arrangements between manufacturers and dealers. Some dealers may carry only the products of a particular manufacturer whereas others may merchandise the products of a number of manufacturers. Under certain contractual arrangements a manufacturer may impose strict constraints upon a dealer's marketing of the manufacturer's products such as requirements for the manufacturer's approval of customer price allowance, customer credit, advertising and promotional campaigns, etc. On the other hand, dealers in many cases have considerable flexibility in such matters.

.45 Revenue recognition by manufacturers for sales of products to dealers generally coincides with the shipment or delivery of the products to the dealer. In some cases, manufacturers may "warehouse" the product for the dealer pending instructions from the dealer for shipment directly to its customer, for addition of customer directed accessories or for other reasons; however, revenue recognition generally coincides with the passage of title to the dealer in such cases.

.46 The practice of establishing allowances for possible product returns coincident with revenue recognition from the sale varies widely. The determination of an allowance for returns is usually closely related to the periodic evaluation of the collectibility of receivables or the potential for loss arising from other financing arrangements because changes in demand factors may affect both receivable collectibility and potential returns. In rare instances, revenue is not recognized by the manufacturer until the time of sale by the dealer to the customer. The use of this method generally involves the overall consideration of many factors such as (1) floor plan or other arrangements which defer payment until resale of the product by the dealer, (2) extended periods of time over which dealer financing is offered (e.g., up to one year or more), (3) the offering of significant price allowances and perhaps absorption of certain dealer costs on slow moving items, (4) a lack of consistent relationship between periodic shipments to the dealer and his ultimate sale to the consumer, and (5) the financial soundness of the dealer.

Toys and Sporting Goods

.47 The business of manufacturing and selling toys and sporting goods is seasonal in nature. Often credit terms postpone payment by the buyer until the normal retailing period has begun. In many cases the buyers have the right to return unsold products to the manufacturers. However, many such companies select fiscal years which correspond closely to their natural business cycle and, as a result, the majority of the products which will ultimately be returned will have been returned before the financial statements for the year are issued.

.48 In these industries, the goods are also often returned not because of any contractual or other right, but because of late deliveries, substituted deliveries and similar operating problems. In some cases, although goods are not returned, the seller may also be exposed to the risks of ownership because discounts are permitted in lieu of return privileges. In most instances, sales are recorded upon shipment, although occasionally consignment accounting is used. If sales are recognized immediately the accounting for returns varies. Allowances are provided in some cases and, in other cases, returns are recognized only as they occur.

Industries Lacking Product Differentiation

.49 Certain companies are characterized by the lack of product differentiation; that is, the company's products and those of its competitors are basically identical. A few examples are generic drugs, chemicals (fertilizer, polyethylene resins, etc.) and certain consumer goods (detergents, etc.). These companies, therefore, compete within the marketing area. In addition to granting a right of return, in some cases the seller retains the risks of ownership through advance sales, extended terms, price protection, etc. Practices are not uniform.

Sales to the Ultimate Consumer

.50 The industry descriptions above are of sales primarily to wholesalers, distributors or retailers, and, as noted, goods may be returned for a variety of reasons. In sales to the ultimate consumer, the consumer may be given the right of return for reason of dissatisfaction with the product. In most cases, a sale is recognized when the consumer obtains possession, and an allowance for returns may or may not be established.

APPENDIX B: SURVEY OF ACCOUNTING LITERATURE

.51 Pervasive revenue recognition principles are set forth in paragraph 150-153 of APB Statement No. 4:

> "Revenue is generally recognized when both of the following conditions are met: (1) the earning process is complete or virtually complete, and (2) an exchange has taken place." (Par. 150)
>
> "Revenue recognized under the realization principle is recorded at the amount received or expected to be received." (Par. 151)
>
> "Revenue is sometimes recognized on bases other than the realization rule. . . . Sometimes revenue is recognized at the completion of production and before sale is made. Examples include certain precious metals and farm products with assured sales prices. The assured price, the difficulty in some situations of determining costs of products on hand, and the characteristics of unit interchangeability are reasons given to support this exception." (Par. 152)
>
> "The realization principle requires that revenue be earned before it is recorded." (Par. 153)

.52 APB Opinion No. 10 provides for recognizing revenue on the installment or cost recovery methods, under conditions in which there is no reasonable basis for estimating the degree of collectibility of revenue. Paragraph 12 of APB Opinion No. 10 reaffirms the statement in Chapter 1A of ARB No. 43, Paragraph 1, that "Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured."

In making this reaffirmation the Opinion also states that the Board "believes that (otherwise) revenues should ordinarily be accounted for at the time a transaction is completed, with appropriate provision for uncollectible accounts."

.53 The AICPA Industry Accounting Guide, *Accounting for Retail Land Sales,* states in Paragraph 13 that "The principle of realization presupposes that title will be transferred at or before the time of profit recognition. Delay in conveyance of title may occur in the real estate industry for a variety of reasons and does not require deferring profit recognition for an otherwise acceptable transaction if the purchaser has the right to receive title when the receivable is paid or at the end of the normal contract period. Receipt of option deposits does not constitute a recordable sale under the realization principle.'' The Guide goes on to state in Paragraph 15: ''The Committee believes that recognition of the sale should be deferred until certain conditions are met that indicate that (a) the customer seriously intends to complete the contract and (b) the company is capable of fulfilling its obligations under the contract so that customers cannot later demand and receive refunds for failure to deliver.'' The Guide sets forth three specific conditions which must be met in order to record contracts as sales. One of the conditions is that ''The customer has made the downpayment and each regularly required subsequent payment until the period of cancellation with refund has expired. That period should be the longest of the period required by local law, established by company policy, or specified in the contract, regardless of whether refunds are available for simple notification, site visitation or otherwise.''

.54 The Guide sets forth conditions for distinguishing between the use of accrual and installment sales methods of accounting for revenue. In general, the conditions for use of the accrual method are based on minimum uncertainties with respect to ultimate collection of sales proceeds. Paragraph 20, Item (d), includes the condition that ''Collection experience for the project indicates that collectibility of receivable balances is reasonably predictable. . . .'' Paragraph 21 amplifies this by saying ''The ability to predict collection results of current sales presumes satisfactory experience on prior sales of the type of land being currently marketed in the project over a sufficiently long collection period to indicate the percentage of sales that will be collected to maturity. Since different sales methods may result in different cancellation and collection experience, historical data available must include experience with respect to each type of sales method used, such as telephone sales, broker sales, site visitation sales, etc.''

.55 This is reiterated in Paragraph 22 which states, ''Thus the Committee concludes that income should be recorded under the accrual method if the company's collection experience can provide information (described in Paragraph 20(d)), that supports a reasonable prediction of whether the required percentage of contracts will pay out to maturity and all other conditions are met. The Committee believes that condition (d) above is vital to provide assurance that the uncertainties regarding collectibility of the remaining receivables are minimized.''

.56 The AICPA Industry Accounting Guide, *Accounting for Profit Recognition on Sales of Real Estate*, states in Paragraph 7, ''Revenue (and profit) is conventionally recognized at the time an asset is sold, provided (a) the amount of the revenue is measurable . . . and (b) the earning process is complete or virtually complete—that is, the seller is not obliged to perform significant activities after the sale in order to earn the revenue.'' In Paragraph 8, it is stated, ''If no reasonable basis exists to estimate the collectibility of the sales price in a transaction, the installment or cost recovery method of accounting is appropriate.'' This is followed in Paragraph 9 with the statement that ''Uncertainty about collectibility of the sales price may require another method of accounting in which the effective date of the sale is deferred until the uncertainty is satisfactorily resolved.'' The Guide also states in Paragraph 11 that ''Economic substance should determine the timing of recognition, amount, and designation of revenue if the economic substance of a transaction differs from its legal form. . . . For example, a transaction that is in the legal form of a sale . . . may be in economic substance . . . a deposit on or an option to purchase the asset. . . .''

.57 Paragraph 12 continues, ''To be accounted for as a sale, a transaction should transfer from the seller to the buyer (a) the usual risks of ownership (for example, obsolescence, unprofitable operations, unsatisfactory performance, idle capacity and dubious residual value). . . . Any risk that is retained by the seller in the asset sold should be limited essentially to that of a secured creditor. Otherwise, accounting for a transaction other than as a sale is required.'' Paragraph 56 of the Guide states the following:

> "The Committee concludes that the following contractual provisions . . . require accounting for the transaction as a financing, leasing, or profit sharing arrangement:
>
> > "A seller has an obligation or an option to repurchase the property. . . ."
> >
> > "A buyer has an option to compel the seller to repurchase the property."
> >
> > "A seller guarantees the return of the buyer's investment. . . ."

.58 The AICPA Industry Accounting Guide, *Accounting for Motion Picture Films,* requires that revenue from films licensed for television not be recognized prior to the fulfillment of five conditions, one of which is that "Collectibility of the full license fee is reasonably assured," and another of which is that "The film has been accepted by the licensee in accordance with the conditions of the license agreement." The Guide further says, "Should options or other factors raise doubt about the obligation or ability to perform on the part of either party, revenue recognition should be delayed until such options or factors no longer exist. Insignificant factors, such as the delivery of a print of a previously accepted film, are not a sufficient basis for delaying revenue recognition." With respect to the acceptance condition the Guide states, "However, certain feature films included in a package may have ratings such that their eventual acceptance by the licensee is so questionable that it would be necessary to delay revenue recognition for such films until unconditionally accepted by the licensee."

.59 The AICPA Industry Accounting Guide, *Accounting for Franchise Fee Revenue,* indicates the conclusion that revenue should not be recognized until the franchisor "has no remaining obligation or intent—by agreement, trade practice or operation of law—to refund any cash already received or to excuse nonpayment of any unpaid notes . . . and . . . any other conditions which affect consummation of the sale transaction have been met."

[.60] [Superseded, effective January 1, 1977, by FASB Statement No. 13.]

ACCOUNTING STANDARDS EXECUTIVE COMMITTEE

January 17, 1975

Stanley J. Scott, Chairman	Irving B. Kroll
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	Alvin Zuckerkorn

ACCOUNTING STANDARDS TASK FORCE ON REVENUE RECOGNITION WHEN RIGHT OF RETURN EXISTS

January 17, 1975

Robert F. Richter, Chairman	Edmund R. Noonan
	Morton B. Solomon
	Robert N. Waxman

Section 10,060

Statement of Position 75-2 Accounting Practices of Real Estate Investment Trusts

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Section 10,060

Statement of Position 75-2 Accounting Practices of Real Estate Investment Trusts

[Recommendation to Financial Accounting Standards Board]

AICPA

American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

June 27, 1975

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying Statement of Position presents recommendations of the Accounting Standards Division on Accounting Practices of Real Estate Investment Trusts. It was prepared on behalf of the Division by the Accounting Standards Executive Committee for consideration by the Financial Accounting Standards Board and for such action as the Board deems appropriate. The scope of the Statement is restricted to REITs, although it is acknowledged that the conclusions therein may also be appropriate for companies which are not REITs.

The Statement takes the position that the allowance for losses on loans and foreclosed properties should now be determined based on an evaluation of the recoverability of individual loans and properties and, in this evaluation, the principle of providing for all losses when they become evident should now require the inclusion of all holding costs, including interest, in determining such losses.

The individual evaluation of the loans and foreclosed properties should be made, according to the Statement, as of the close of all annual and interim stockholder reporting periods. This may well result in a need to increase or decrease the allowance for losses with a corresponding charge or credit to income. However, in the case of foreclosed property which the REIT elects to hold as a long-term investment, the Statement concludes that the net realizable value of such property at the date of foreclosure becomes its new basis, and subsequent increases in market values of such properties should generally not be recorded until the time of a later exchange transaction which confirms the amount of any increase.

The Statement also takes the position that recognition of interest revenue should be discontinued when it is not reasonable to expect that the revenue will be received and enumerates conditions which should now be regarded as establishing a presumption that the recording of interest should be discontinued.

Finally, the Statement concludes that commitment fees should be amortized over the combined commitment and loan period, and provides guidance with respect to appropriate accounting by a REIT for operating support from its adviser.

The Division would appreciate being advised as to the Board's proposed action on the recommendations set forth in this Statement of Position.

Sincerely yours,

Stanley J. Scott

STANLEY J. SCOTT

Chairman

Accounting Standards Division

cc: Securities and Exchange Commission

NOTES

Statements of Position of the Accounting Standards Division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of Statements of Position is to influence the development of accounting and reporting standards in directions the Division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, Statements of Position do not establish standards enforceable under the Institute's Code of Professional Ethics.

ACCOUNTING PRACTICES OF REAL ESTATE INVESTMENTS TRUSTS *

INTRODUCTION

.01 Real estate investment trusts (REITs) have in recent years assumed an increasingly important role in the real estate industry. REITs are business trusts and are generally publicly-held. They employ equity capital, coupled with substantial amounts of debt financing, in making real estate loans and investments.

.02 A REIT, if it so elects, will not be required to pay Federal corporate income taxes (other than that on "tax preference" items) if, among other things, at least 90% of its taxable income, as defined, is distributed to its shareholders. This Statement, however, is not restricted to those REITs which have elected such tax treatment.

.03 The accounting problems discussed in this Statement of Position may also be encountered by other companies which are not REITs but which are engaged in the business of making loans on or investing in real estate. The conclusions in this

* See also section 10,170.

Statement of Position may, therefore, also be appropriate for those companies. However, the accounting practices of companies which are not REITs are beyond the scope of this Statement of Position.

.04 REITs have engaged in a variety of lending and investing activities, some of which are listed below.

Construction loans are generally short-term first mortgage loans to finance the construction of residential, commercial or industrial properties. Interest revenue on such loans is usually accrued and added to the loan balance, which is paid from the proceeds of permanent financing.

Development loans are short-term first mortgage loans to finance site development costs. They are usually paid from proceeds of a construction loan.

Land acquisition loans are first mortgage loans to finance the acquisition (not the development) of sites.

Long and intermediate term loans are generally conventional mortgage loans to finance completed properties.

Purchase leasebacks consist of the simultaneous purchase and leaseback to the seller of real estate properties.

Equity investments in real estate are direct ownership interests, under a variety of forms, in improved or unimproved real estate.

Junior mortgage loans are real estate loans subject to the lien of a prior mortgage.

Wrap-around loans are junior mortgage loans to provide an owner with funds without disturbing a prior first mortgage loan which, for various reasons, is not liquidated.

Gap loans are junior mortgage loans to finance a temporary spread between amounts advanced and amounts committed under a prior first mortgage loan.

Warehousing loans are short-term loans secured by the pledge of mortgage loans.

.05 In connection with real estate loans, a REIT may issue a commitment, which is an agreement to make a mortgage loan in the future at specified terms.

.06 A REIT's financial success is often dependent upon external factors, among which are the operations of its contractor-borrowers, the availability to those contractors of long-term mortgage funds when projects are completed, and the general condition of the real estate industry. The success of the REIT is also dependent upon its ability to obtain financing at rates less than that earned on its portfolio of investments.

.07 Considerable attention has recently been given to the accounting practices of REITs, particularly those which relate to loans which are in default or may become in default. This Statement of Position addresses certain of those practices.

LOSSES FROM LOANS

.08 REITs are subject to the usual risks associated with loans, investments in real estate, and commitments to make loans. These risks include adverse changes in economic conditions, both national and local, changes in interest rates, availability of mortgage financing, supply and demand for properties in specific areas, and governmental actions such as zoning and environmental regulations, among many others.

.09 REIT industry practices vary considerably with respect to providing for losses resulting from their lending activities. The Division believes it is desirable to narrow the range of acceptable practices.

.10 When it appears that an original borrower will be unable to make the payments required by the terms of his loan agreement, a REIT has several alternatives. It can place the loan in a "work-out" status with the expectation that its financial position with respect to the loan will be improved through careful monitoring of the borrower's activities coupled with continued advances on the loan when necessary. It may renegotiate the terms of the loan with the original borrower with the hope that more liberal lending terms will insure at least partial recovery of principal and interest. It may search for another borrower to assume management of the real estate collateralizing the loan and to assume responsibility for the loan. It may initiate foreclosure proceedings or accept a deed in lieu of foreclosure to obtain title to the property collateralizing the loan.

.11 Depending on the state in which property is located and depending on the complexity of a borrower's financial arrangements, foreclosure proceedings may be time consuming. However, once foreclosure has been effected, the REIT has two alternative courses of action: to dispose of the property or to hold it for investment. In either case, the REIT may have to invest additional funds to bring the property to salable and/or income-producing condition.

.12 Whether a loan appears to be "good" or "troubled" and whether a REIT elects to foreclose on a troubled loan or chooses one of the other alternatives mentioned above, it is in all cases not so much the credit standing of the borrower which is studied in determining recoverability as it is the real estate which serves as collateral for the loan. The reason for this is that in few cases would a REIT's borrower be able (or willing) to repay a loan from other sources.

.13 Accordingly, the Division believes that the essential problem to be addressed relates to the valuation of real estate and that the conclusions reached in this Statement of Position are equally applicable to the determination of allowances for losses on loans (both "good" and "troubled") and on foreclosed properties.[1] In addition, the initial valuation method should be the same for foreclosed properties held for resale and those held as an investment.[2] The Division's objective is to identify a method of providing for losses which will result in an allowance which is, in the aggregate, reasonable in the context of the financial statements taken as a whole. [As amended by Statement of Position No. 78-2.] (See section 10,170.)

.14 Three methods for determining a provision for loan losses for REITs have been predominantly followed in practice, as discussed below.

Systematic Provision—Some REITs establish a provision for losses in what is considered to be a systematic manner. The most common methods are to base the provision on a fixed percentage of loans or net income.

Individual Evaluation—Some REITs establish a provision for losses based on an evaluation of the individual loans or foreclosed properties to estimate the amount of any loss that may reasonably be expected.

Combination Method—Other REITs record a provision for losses equivalent to an amount determined by evaluation of at least certain major or problem loans and foreclosed properties, increased by a provision which generally represents a percentage of loans or of net income.

.15 The Division believes that the allowance for losses should now be determined based on an evaluation of the recoverability of individual loans and properties which gives consideration to the facts and circumstances in existence at the time of the evaluation and to reasonable probabilistic estimates of future economic conditions and other relevant information. The allowance should not be determined on the basis of percentages of loan balances, income or other similar bases.

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[1] Statement of Financial Accounting Standards No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings,* prescribes the accounting required for assets received or transferred in troubled debt restructurings consummated after December 31, 1977, with earlier application encouraged. The recommendations in this section, "Losses from Loans," concerning loans and properties have been amended in certain respects to conform with FASB Statement No. 15. (See "Assets Affected by Troubled Debt Restructurings.") The recommendations in this section continue to apply to foreclosed properties acquired before the effective date of FASB Statement No. 15 and for which earlier application of that Statement is not elected.

[2] See, however, paragraph .27 for additional comments with respect to foreclosed property held as a long-term investment.

.16 Because of the many factors which can affect recoverability, the *estimated* loss on an individual loan or property may not be the same as the ultimate loss, if any, *actually* sustained on each. While the individual evaluation method, like all estimation methods, inherently lacks precision, it best achieves, in the Division's view, the ultimate objective of determining an allowance for losses which is, in the aggregate, reasonable in the context of the financial statements taken as a whole.

.17 Evaluation of the recoverability of individual loans and properties entails a comparison of the carrying amount (including recorded accrued interest, but not previously determined allowances for losses) of each such loan or property with its estimated net realizable value. With respect to a REIT, estimated net realizable value means the estimated selling price a property will bring if exposed for sale in the open market, allowing a reasonable time to find a purchaser, reduced by (a) the estimated cost to complete and improve such property to the condition used in determining the estimated selling price, (b) the costs to dispose of the property, and (c) the estimated costs to hold the property to the estimated point of sale, including interest, property taxes, legal fees and other cash requirements of the project. However, some REITs, because of liquidity problems or for other reasons, may not be able or willing to hold foreclosed property and, therefore, must estimate the selling price on an immediate liquidation basis.

.18 Some do not believe that estimated interest holding costs should be considered in the determination of estimated net realizable value. They point out that, with limited exceptions, interest has been traditionally considered a period cost. They believe that this recommended practice is a part of the broader problem of recognition of the cost of capital and argue that it is inappropriate to reach a conclusion with respect to REITs before that broader problem is resolved. In the real estate industry, interest is clearly an economic cost of holding property and, therefore, the Division does not find these arguments persuasive. In the case of a REIT, the Division believes that the principle of providing for all losses when they become evident should now require the inclusion of all holding costs, including interest, in determining such losses.

.19 Some would support the Division's position if it were restricted to investments which are expected to be held in excess of a stipulated minimum period of time related to the operating cycle of a REIT. The Division does not agree with this view.

.20 The Division believes that the guidelines described below should be followed with respect to estimating interest holding costs in the determination of estimated net realizable value.

.21 The interest rate should be estimated based on the average cost of all capital (debt and equity). This rate should be calculated by dividing debt interest costs by the aggregate of equity capital and debt. Debt interest costs should normally be based on the interest rate used for accruing interest expense at the date of the balance sheet. However, information available prior to the issuance of the financial statements (e. g., renegotiation of the REIT's debt) should be considered in determining whether that rate is appropriate. The objective is to arrive at a rate which would, *in the light of existing agreements,* correspond with the rate to be used for accruing interest expense during the estimated holding period of the property.

.22 Examples of the application of these guidelines, using present value techniques, are included in the appendices to this Statement of Position.

.23 The effective rate of interest used in the calculations should be disclosed in the notes to financial statements.

.24 A minority of four members of the Accounting Standards Executive Committee dissent from the procedure recommended above for the determination of net realizable value. In their view, treating interest cost in the manner specified results in valuing an asset differently depending upon (1) the credit standing of the entity and the resultant interest rate required to be paid on debt and (2) the entity's capital structure, i. e., the mix of debt and equity. The minority believes that net realizable value should be determined by looking only to the asset and the market considerations related to it, which should result in the same measurement for any entity whose use of the asset is the same, i. e., the net realizable value of the asset should not be affected by which entity owns it or how that entity is capitalized. In this regard, they see no reason to distinguish real estate assets from other assets.

.25 As previously noted, the individual evaluation method entails a determination of the net realizable value of the property. Some factors to be considered in the valuation of property are as follows:

(1) The current status or nature of the property and its condition.

(2) The current actual use of the property and the future uses of the property as related to general economic conditions and the population growth in the area.

(3) The overall suitability of the property for its current or intended use.

(4) Various restrictions including zoning and other possibilities.

(5) Comparable prices of other properties in the area.

.26 The individual evaluation of loans and foreclosed properties should be made as of the close of all annual and interim stockholder reporting periods.

.27 The periodic evaluation of loans and foreclosed properties may well result in a need to increase or decrease the allowance for losses with a corresponding charge or credit to income. An exception to the foregoing should be made in the case of foreclosed property which the REIT elects to hold not for sale but as a long-term investment. The net realizable value of such property at the date of foreclosure becomes its new basis, in accordance with generally accepted accounting principles for long-term investments. Subsequent increases in market values of such properties should generally not be recorded until the time of a later exchange transaction which confirms the amount of any increase. (See APB Statement No. 4, Paragraph 183.)

.28 The Division believes that the appropriate presentation of loans, foreclosed property held for resale, and the allowance for losses in the balance sheet would be as follows:

Loans, earning	$xxx	
Loans, nonearning	xxx	
Foreclosed properties held for resale	xxx	
	$xxx	
Allowance for losses	$xxx	$xxx

.29 There are numerous conditions which may indicate that a loss will be incurred on a loan. Some of these conditions are discussed in paragraphs .30—.38.

ASSETS AFFECTED BY TROUBLED DEBT RESTRUCTURINGS

.29A Properties acquired by an REIT in a troubled debt restructuring and accounted for in accordance with FASB Statement 15 should be recorded as if they had been acquired for cash at their fair value, which becomes their cost basis for accounting purposes. Periodically thereafter the properties should be evaluated and allowances for losses should be provided in accordance with the recommendations on "Losses from Loans."

.29B When it is probable that an REIT will enter into a troubled debt restructuring with one of its *debtors* that will result in a loss determined in accordance with the provisions of FASB Statement 15 in excess of the allowance, if any, provided in accordance with the recommendation on "Losses from Loans" in this Statement, a provision should be made for the excess loss. Thereafter, until the restructuring occurs, the loan receivable should be periodically evaluated in a similar manner, and the allowance for losses should be adjusted at each evaluation date for changes in the estimated loss. In no event should the loan, less the allowance for loss, exceed its estimated net realizable value.

.29C When it is probable that an REIT will enter into a troubled debt restructuring with one of its *creditors* that will result in a loss on transfer of an identified asset (determined in accordance with FASB Statement 15) in excess of the allowance, if any, provided in accordance with the recommendations on "Losses from Loans" in this Statement, a provision should be made for the excess loss on the identified asset to be transferred net of the related gain, if reasonably determinable, on reduction of the payable that will result from the asset transfer. The Accounting Standards Division believes that it is appropriate to include the effect of the gain in providing for the additional loss, because it is the asset transfer that produces both the loss on transfer and the gain on restructuring. The provision for the excess net loss should be reported as an expense in determining income before extraordinary items. After providing for the excess net loss, the allowance for losses will be an amount that reduces the carrying amount of the identified asset to be transferred to its estimated fair value, net of the related estimated gain (not in excess of the loss on the identified asset to be transferred) on the reduction of the payable that will result from the asset transfer. In no event, however, should the identified asset to be transferred, less the allowance for losses, exceed its estimated net realizable value. The notes to the REIT's financial statements should disclose the effect on the allowance for losses of the estimated gain on the payable to be restructured as described in the preceding sentence. Also, the note should state that, when realized, such gain will be reported as an extraordinary item with a corresponding charge to income before the extraordinary item.

[As amended by Statement of Position 78-2.] (See section 10,170.)

DISCONTINUANCE OF INTEREST REVENUE RECOGNITION

.30 While some REITs argue that recognition of interest revenue should never be discontinued, it seems clear that there is no sound basis in theory or practice for such a position, since it is well established in accounting that if sufficient doubt or uncertainty exists as to realization, recognition may not be appropriate.

.31 In practice, the recognition of interest revenue has usually been discontinued at one of the following points:

(1) When the amount of any final loss can be determined with a high degree of precision (e. g., upon final settlement).

(2) Upon the occurrence of certain specified events (e. g., interest or principal is a certain number of days past due, cost overruns are at a certain percentage, foreclosure proceedings are being initiated, etc.)

(3) When judgment—often involving an evaluation of total loan recoverability, including estimated recoverability from foreclosure and sale—indicates that any additional interest would not be realized.

.32 Postponing the discontinuance of interest recognition until a loss can be determined with a high degree of precision is in conflict with general practice and theory.

.33 A common practice is to discontinue the recognition of interest upon the occurrence of certain specified events. Its attractiveness lies in the ability to determine objectively if the criteria have been met and, as a result, it is presumed there would be a greater uniformity in the reported results of REITs following this practice.

.34 Opponents of this practice acknowledge that specific criteria may be useful in identifying potential problem loans but believe that arbitrary rules cannot be a substitute for management's judgment. It is argued that even though a loan may meet an established criterion for the discontinuance of interest recognition, it is still possible that the loan and the interest will ultimately be collected; thus, to discontinue recognition in such a situation is as incorrect as recognizing interest when it is clear it will not be collected.

.35 The Division believes that the recognition of interest revenue should be discontinued when it is not reasonable to expect that the revenue will be received. The Division also believes that certain conditions, such as any one of the following, should now be regarded as establishing a presumption (which may be overcome if other facts clearly refute the presumption) that the recording of interest should be discontinued.

(1) Payments of principal or interest are past due.

(2) The borrower is in default under the terms of the loan agreement.

(3) Foreclosure proceedings have been or are expected to be initiated.

(4) The credit-worthiness of the borrower is in doubt because of pending or actual bankruptcy proceedings, the filing of liens against his assets, etc.

(5) Cost overruns and/or delays in construction cast doubt on the economic viability of the project.

(6) The loan has been renegotiated.

These conditions may also be an indication that an allowance for losses should be provided.

.36 The Division supports the view that the discontinuance of interest revenue recognition is related to the question of realization and, consequently, such recognition should not be resumed, nor should unrecorded interest be recognized, until it is evident that the principal and interest will be collected.

.37 Some believe that even though the recognition of interest is discontinued, interest revenue should be "grossed up" with an offsetting charge to an expense account. They believe that this presentation will more clearly reflect the planned income from the portfolio as well as the deviations, in the form of provisions for possible losses, from that plan.

.38 Others maintain that since the interest recognition was discontinued because realization was doubtful, it would not be appropriate to include such amounts in interest revenue in the financial statements because such a presentation would contradict economic reality. The Division supports this view.

COMMITMENT FEES

.39 A commitment fee can be defined generally as any fee paid by a potential borrower to a potential lender for a promise to lend money in the future. Recording commitment fees is complicated by the fact that some commitments (such as many gap and stand-by commitments) are not expected to be funded.

.40 A REIT may enter into a commitment agreement without having specifically earmarked funds to honor that commitment and it may have no expectation of ever having to honor the commitment. However, circumstances beyond the control of the REIT can change drastically and the REIT may be called upon to honor the commitment.

.41 While the Division agrees that it may be possible to distinguish between commitments which are expected to be funded and those which are not, it believes that it is not possible to make such a distinction on a practical basis.

.42 The available alternatives for the recognition of income from commitment fees are listed below.

(1) Immediate recognition

(2) Deferral and amortization—

(a) Over the commitment period

(b) Over the combined commitment and loan period

(c) Over the loan period

(3) Deferral with immediate recognition when it is clear the commitment will not be funded or with recognition as "points" when the commitment is funded

.43 In general, industry practice has been to recognize commitment fees immediately upon receipt.

.44 Those who would defer the fee over the commitment period—whether amortizing it during that period or making a decision as to appropriate accounting at the end of that period—relate the fee to the commitment itself. Those who would defer the fee and amortize it over the loan period consider the fee an adjustment of the interest on the loan.

.45 Others argue that the fee may be a combination of an adjustment of interest, a fee for ear-marking funds, and/or an offset to the underwriting costs. They believe it is not practicable to separate the components and amortizing the fee over the combined commitment and loan period more closely accounts for all three components on an overall basis.

.46 The Division believes that this latter view should now be regarded as appropriate for a REIT. The straight-line method of amortization should be used during the commitment period and the interest method should be used for the remaining balance during the loan period.[1] Deferred commitment fees should be taken into income at the end of the commitment period if the loan is not funded.

OPERATING SUPPORT OF THE REIT BY THE ADVISER

.47 Various methods are or have been employed by advisers to insure a certain return to the REIT for certain periods. Some of these methods are summarized below.

(1) Purchasing a loan or a property at an amount in excess of market value

(2) Forgiving indebtedness

(3) Reducing advisory fees

(4) Providing required compensating balances

(5) Making outright cash payments

.48 In situations of this type, few would challenge the need for disclosure of the nature of the relationship between the REIT and its adviser and the nature and amount of the transactions between them. The accounting for the transaction, however, is not quite as clear.

.49 Some believe that operating support given to a REIT by its adviser can be determined to be either income or a contribution to capital on the basis of the form of the transaction.

.50 Others hold that such support should always be accounted for as income since it is difficult, if not impossible, to distinguish items of income from capital contributions. In some cases, for example, determining what the terms of an "arms-length" transaction would be might pose significant problems. Distinguishing between the types of operating support would also pose problems—why, for example, should a loan purchased at more than market value by the adviser be viewed differently from a reduction in the advisory fee?

.51 The Division believes that in the present framework of generally accepted accounting principles, appropriate account-

[1] If the commitment period were 24 months and the loan period were 25 years (300 months), monthly amortization during the commitment period would be 1/324 of the commitment fee.

ing by a REIT for operating support from its adviser would include the following:

(1) Adjustment of any assets (or liabilities) which will be transferred between the companies to current market value as of the date of the transaction.

(2) Recognition, as income or as a reduction of advisory fees, of the operating support effectively obtained, with full disclosure of (a) the relationship between the parties and (b) the nature and amount of the transactions.

.52 The effect of such transactions, when material, should be reported separately in the income statement.

* * * * *

.53 APPENDIX A: ILLUSTRATION A

Purpose of Illustration

This appendix illustrates the accounting by a REIT for a loan on a project in the development stage when the developer is unable to complete the project. Evaluation of the carrying value of the loan requires the determination of the estimated selling price of the property and estimated costs to complete construction, to carry the project to the point of disposition, and to dispose of the property. The required allowance for loan losses is determined by comparing the loan receivable balance with the discounted value of estimated future net cash receipts and disbursements.

Assumptions

• Loan receivable balance at evaluation date—			$ 20,500,000
• Estimated selling price of the property when completed in three years, reduced by estimated costs of disposal—			$ 35,000,000
• Construction and carrying costs to complete, exclusive of interest—			
Year 1	($416,667 monthly)	$5,000,000	
Year 2	($250,000 monthly)	3,000,000	
Year 3	($ 83,333 monthly)	1,000,000	$ 9,000,000

- Capitalization of REIT—

Debt (average rate is 12%)	$300,000,000
Equity	60,000,000
Total	$360,000,000

  Accordingly, the average cost of all capital is 10% (12% of $300,000,000 ÷ $360,000,000).

- Construction and carrying costs are incurred ratably throughout each year. There is no occupancy prior to disposition.
- The REIT intends to support the project until disposition and to recover its loan on a work-out basis, and it has the financial capacity to do so.

Determination of Required Allowance for Loan Losses

Loan receivable balance	$20,500,000
Less present value of estimated future net cash receipts and disbursements, exclusive of interest, at the average cost of all capital (10%) (Note a)	17,870,000
Required allowance for loan losses	$ 2,630,000

* * * * *

Computational Notes (Note b)

Present value of estimated future cash receipts ($35,000,000 × .7417) =	$25,960,000
Present value of estimated future cash disbursements—	
$416,667 × 11.3745 × 1.0000 =	$ 4,739,000
$250,000 × 11.3745 × .9052 =	2,574,000
$ 83,333 × 11.3745 × .8194 =	777,000
	$ 8,090,000
	$17,870,000

Notes—

(a) Determining the required allowance for loan losses by deducting the present value of estimated future net cash receipts from the loan receivable balance at the evaluation date in effect builds into the calculation the interest costs to carry the project to the point of disposition.

(b) See Appendix C for present value factors.

.54 **APPENDIX B: ILLUSTRATION B**

Purpose of Illustration

This appendix illustrates the accounting by a REIT for a loan on a completed multi-unit apartment project in the rent-up stage when the cash flow to the developer before debt service is insufficient to meet the required payments on the REIT's loan. Evaluation of the carrying value of the loan requires determination of the estimated selling price of the property and estimated net cash inflows and outflows from rental operations, giving effect to projected occupancy rates. The required allowance for loan losses is determined by comparing the loan receivable balance with the discounted value of estimated future net cash receipts and disbursements.

Assumptions

• Loan receivable balance at evaluation date —	$ 4,500,000
• Occupancy is estimated to average 40% in the first year, 70% in the second year, and 95% thereafter. Occupancy rates are determined after allowing for turnover. Monthly rentals are estimated to be $200 per unit (300 units).	
• Estimated selling price of the property at 95% occupancy with capitalization of operating cash flow at 10%—	$ 4,620,000
• Capitalization of REIT—	
Debt (average rate is 12%)	$100,000,000
Equity	50,000,000
Total	$150,000,000

Accordingly, the average cost of all capital is 8% (12% of \$100,000,000 ÷ \$150,000,000).

- The REIT intends to support the property for two years. At the end of that period it intends to recover its investment and to pay its lender. The REIT has the financial capacity to do so. Cash flow before debt service is estimated as follows:

  Year 1 — \$ 4,400 per month

  Year 2 — \$21,400 per month

- Two alternative assumptions for repayment of the REIT's lenders are illustrated: Assumption 1—Interest on debt remains at 12% for the two year period; Assumption 2—Interest on debt remains at 12% for six months but will be reduced at that point to 6% according to a contractual arrangement.

Determination of Required Allowance for Loan Losses

	Assumption 1	*Assumption 2*
Loan receivable balance	\$4,500,000	\$4,500,000
Less present value of estimated future net cash receipts and disbursements, exclusive of interest, at the average cost of all capital:		
Selling price	\$3,939,000	\$4,181,000
Operating cash flow	278,000	293,000
	\$4,217,000	\$4,474,000

	Assumption 1	*Assumption 2*
Required allowance for loan losses	$ 283,000	$ 26,000

* * * * *

Computational Notes

Present value of selling price—

Estimated selling price	$4,620,000	$4,620,000
Present value factors—		
8% (average cost of capital) for 24 months	.8526	
8% (average cost of capital) for 6 months		.9609
4% (average cost of capital) for 18 months		.9419
	$3,939,000	$4,181,000

Present value of net operating cash flow, before debt service—

Year 1		
Monthly cash flow	$ 4,400	$ 4,400
Present value factor	11.4958	5.8625
		$ 26,000
Monthly cash flow		$ 4,400
Present value factor		(5.9306 × .9802)
		$ 26,000
	$ 51,000	$ 52,000

	Assumption 1	Assumption 2
Year 2		
Monthly cash flow	$ 21,400	$ 21,400
Present value factor	(11.4958 × .9234)	(11.7440 × .9609)
	$ 227,000	$ 241,000
	$ 278,000	$ 293,000

Note—See notes (a) and (b) on page 17,916.

.55 APPENDIX C: PRESENT VALUE FACTORS

Present Value of $1

Annual Rate	*Periods**	*Factor*
10%	12	.9052
10%	24	.8194
10%	36	.7417
8%	6	.9609
8%	12	.9234
8%	24	.8526
4%	6	.9802
4%	12	.9609
4%	18	.9419

Present Value of $1 Per Period

Annual Rate	*Periods**	*Factor*
10%	12	11.3745
8%	6	5.8625
8%	12	11.4958
4%	6	5.9306
4%	12	11.7440

* Interest compounded monthly.

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Section 10,070

Statement of Position 75-3 Accrual of Revenues and Expenditures by State and Local Governmental Units

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Section 10,070

Statement of Position 75-3 Accrual of Revenues and Expenditures by State and Local Governmental Units

[Proposal to Financial Accounting Standards Board to Amend AICPA Industry Audit Guide on Audits of State and Local Governmental Units]

AICPA

American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, N.Y. 10036 (212) 575-6200

July 31, 1975

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying Statement of Position, prepared by the AICPA Subcommittee on State and Local Governmental Auditing, proposes amendments to the AICPA Industry Audit Guide on Audits of State and Local Governmental Units which will clarify that part of Chapter 2 of the Guide which deals with accruals of revenues and expenditures by state and local governmental units.

While issuance of this Statement of Position will be helpful to independent auditors, we urge that FASB advise the accounting profession at an early date as to whether it believes the proposed amendments are appropriate and should be regarded as having the same authoritative support as the Audit Guide itself.

Members of the Subcommittee will be glad to meet with you or your representatives to discuss this proposal. The Subcommittee would also appreciate being advised as to the Board's proposed action on its recommendations.

Sincerely yours,

AICPA SUBCOMMITTEE ON
STATE AND LOCAL GOVERNMENTAL AUDITING

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cc: Securities and Exchange Commission

NOTES

The American Institute of Certified Public Accountants has issued a series of industry-oriented Audit Guides that present recommendations on auditing procedures and auditors' reports and in some instances on accounting principles, and a series of Accounting Guides that present recommendations on accounting principles. Based on experience in the application of these Guides, AICPA Task Forces or Subcommittees may from time to time conclude that it is desirable to change a Guide. A Statement of Position is used to revise or clarify certain of the recommendations in the Guide to which it relates. A Statement of Position represents the considered judgment of the responsible AICPA Task Force or Subcommittee.

To the extent that a Statement of Position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the Audit Guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the Subcommittee.

To the extent that a Statement of Position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the Subcommittee are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the Subcommittee believes would be in the public interest.

AUDITS OF STATE AND LOCAL GOVERNMENTAL UNITS

Proposed Amendment to Industry Audit Guide

BACKGROUND INFORMATION

.01 The accrual basis of accounting is followed (with minor exceptions) by all funds other than budgetary funds of state and local governmental units. Budgetary funds (general, special revenue, and debt service funds) use the modified accrual basis of accounting. The AICPA Industry Audit Guide, *Audits of State and Local Governmental Units,* summarizes the modified accrual basis as follows:

1. Revenues are recorded as received in cash except for
   (a) revenues susceptible to accrual and
   (b) material revenues that are not received at the normal time of receipt.
2. Expenditures are recorded on an accrual basis except for
   (a) disbursements for inventory type items, which may be considered expenditures at the time of purchase or at the time the items are used;

(b) prepaid expenses, which normally are not recorded;

(c) interest on long-term debt, which should normally be an expenditure when due; and

(d) the encumbrance method of accounting, which may be adopted as an additional modification.

.02 Although the Guide contains a discussion of the application of both the accrual and modified accrual bases of accounting to revenues and expenditures, questions have arisen in practice with respect to four problem areas: sales taxes, revenue sharing, vacation and sick pay, and interest accruals in special assessment funds. Accordingly, this Statement of Position has been issued to revise or clarify that part of Chapter 2 of the Guide dealing (a) with the modified accrual basis, and (b) with the concept "fully matured and not paid" as it pertains to interest accruals in assessment funds.

REVENUES SUSCEPTIBLE TO ACCRUAL

.03 The Guide describes, on page 14, criteria to identify revenues susceptible to accrual, as follows:

> Revenues considered susceptible to accrual are those revenues that are both measurable and available. In substance, "available" means that the item is a resource that can be used to finance the governmental operations during the year.
>
> Few types of revenues in budgetary funds possess all of the characteristics essential to meet both criteria of being measurable and available, which are requisite to being considered susceptible to accrual.
>
> Revenue sources that generally are not considered susceptible to accrual include those generated on a self-assessed basis, such as income taxes, gross receipts taxes, and sales taxes. Normally, such taxes would be recorded as revenue when received.

The Subcommittee believes the Guide should be amended to clarify the application of these criteria to sales taxes and to revenue sharing entitlements.

.04 Specifically, the Subcommittee believes that *Audits of State and Local Governmental Units* should be amended by inserting the following paragraphs immediately before the first full paragraph (beginning "Normally, when an item is billable. . . .") on page 15:

The following paragraphs illustrate the application of these criteria.

Sales taxes collected by merchants but not yet required to be remitted to the taxing authority at the end of the fiscal year should not be accrued. However, taxes collected and held by one government agency for another at year end should be accrued if they are to be remitted in time to be used as a resource for payment of obligations incurred during the preceding fiscal year. To illustrate, when a state collects all sales taxes and within 60 days remits to cities and counties the amounts collected for them, amounts held by the state for allocation on June 30 should be accrued by cities and counties with a June 30 fiscal year end. However, taxes collected by merchants during June and prior months but not required to be remitted until after June 30 should not be accrued by the state, counties, or cities.

Revenue sharing entitlements are for the period from July 1 to June 30 and are received in four installments, the last of which is not received until July. This final installment, which is both measurable and available, should be accrued at June 30 as a resource of the fund accounting for the initial receipt of revenue sharing entitlements.

VACATION PAY AND SICK PAY

.05 The Guide states, on page 16, that "Expenditures are recorded on the accrual basis. . . ." and goes on to discuss certain exceptions to that statement. The Subcommittee believes the Guide should be amended to permit state and local governmental units not to record the costs of vacation and sick leave at the time the benefits are accumulated.

.06 Specifically, the Subcommittee believes that *Audits of State and Local Governmental Units* should be amended by inserting the following paragraphs immediately before the last full paragraph (beginning "A summary of the modifications. . . .") on page 16:

Governmental units, like commercial and other organizations, provide vacation and sick pay benefits to their employees. However, governmental units often have policies or contractual agreements which permit employees to accumulate unused vacation and sick pay over their working careers and to redeem such unused leave time in cash upon death or retirement or by extended absence immediately preceding retirement. Portions of amounts accumulated at any point in time can be expected to be redeemed before termination of employment. While such accumulations may be material in total, the effect on the financial statements of any one year may be immaterial. However, the effect on any one year may become material if the governmental unit is required to liquidate the accrued amounts, e. g., because of a court action by employees.

Although governmental units generally should record expenditures on the accrual basis, the accounting for unused vacation and sick pay needs to be considered in light of the unique environment of governmental units. Budgetary funds of governmental units, unlike business entities, are not concerned with the principle of matching costs against associated revenues. Rather, a major interest of governmental financial statement users is the fiduciary responsibility of the governmental body for the revenues appropriated. Further, long-term debts of budgetary funds are not recorded as debts in the fund which will be making the requisite payments but rather in the long-term debt group of accounts.

Considering these factors and the nature of the accumulated unused vacation and sick leave, it is appropriate to disclose the estimated amount of such commitments in a footnote, if material, and not record the costs as expenditures at the time the leave is accumulated. If accumulated unused vacation and sick pay at the end of a fiscal year does not exceed a normal year's accumulation, footnote disclosure is not required.

INTEREST ACCRUALS IN ASSESSMENT FUNDS

.07 The Guide states, on page 13, that "In special assessment funds, interest income on assessments receivable and interest expense on offsetting bonds payable or other long-term debt should not be accrued unless fully matured and not paid." The Subcommittee believes this statement should be clarified by a footnote, as set forth below:

This principle applies whether or not the date for payments to bondholders coincides with the date for collections from property owners; for example, if interest from property owners is due on March 1 and the corresponding payment to bondholders is payable on June 1, the entity would report as interest receivable on June 30 only the amounts still uncollected from property owners for the preceding March 1 and prior interest dates. The interest payable reported at June 30 should be only the amounts still payable to bondholders for the preceding June 1 and prior interest dates.

Section 10,080

Statement of Position 75-4 Presentation and Disclosure of Financial Forecasts

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Section 10,080

Statement of Position 75-4 Presentation and Disclosure of Financial Forecasts

August 1975

NOTES

Statements of Position of the Accounting Standards Division are issued for the general information of those interested in the subject. This Statement represents the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting, cost accounting, and financial forecast presentation. However, Statements of Position do not establish standards enforceable under the Institute's Code of Professional Ethics.

The objective of this Statement of Position is to provide general information and guidance to members and others on the *Presentation and Disclosure of Financial Forecasts.*

INTRODUCTION

.01 This Statement of Position on *Presentation and Disclosure of Financial Forecasts* has been issued by the Accounting Standards Division of the American Institute of Certified Public Accountants because greater interest is being shown in financial forecasts and projections[1] and they increasingly are being disseminated.

.02 Few companies publish forecasts or projections for general dissemination at present. Many companies, however, issue forecasts or projections to lenders, underwriters and prospective investors in connection with obtaining debt or equity financing. They are included in offering circulars for bond issues to finance the construction of hospitals, airports, sports arenas and other public facilities, as well as in offering circulars for limited partnership interests, particularly in real estate.

.03 The Securities and Exchange Commission has historically prohibited the inclusion of forecasts or projections in prospectuses and reports filed with it. However, the Commission has

[1] See *Definitions,* pars. .05-.09.

proposed changes in that policy to permit companies to include certain statements regarding future operations in filings made pursuant to the Securities Act and the Exchange Act.[2]

.04 Other Divisions within the AICPA are concerned with related aspects of financial forecasts:

a. *Guidelines for Systems for the Preparation of Financial Forecasts* have been issued by the Management Advisory Services Division (MAS Guideline Series Number 3, March 1975). The guidelines provide direction to the developers of forecasting systems and to the preparers of financial forecasts.

b. The Auditing Standards Division is studying matters relating to a CPA's involvement with his client's financial forecasts and the appropriate reporting by a CPA on such forecasts.

DEFINITIONS

.05 Common usage in practice has not developed complete agreement on the definition of certain terms such as *forecast, projection, feasibility study,* and *budget.* For purposes of this Statement of Position, certain definitions have been adopted and used throughout.

Financial Forecast

.06 A financial forecast for an enterprise is an estimate of the most probable financial position, results of operations and changes in financial position for one or more future periods.

In this context—

a. "Enterprise" means an entity for which financial statements could be prepared in accordance with generally accepted accounting principles.

b. "Most probable" means that the assumptions have been evaluated by management and that the forecast is based on management's judgment of the most likely set of conditions and its most likely course of action.

Financial Projection

.07 A financial projection for an enterprise is an estimate of financial results based on assumptions which are not necessarily the most likely. Financial projections are often developed as a response to such questions as "What would happen if?".

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[2] Securities Act Release No. 5581, April 28, 1975.

Feasibility Study

.08 A feasibility study is an analysis of a proposed investment or course of action. A feasibility study may involve the preparation of financial projections and/or a financial forecast. A financial forecast may in turn be based on the results of a feasibility study used in the formulation of management's plans.

Budgets, Plans, Goals, and Objectives

.09 Budgets, plans, goals, and objectives also involve elements of predicting the future. However, each tends to have elements which distinguish it from a financial forecast although, in some situations, each may be identical to a forecast. Budgets, plans, goals, and objectives may have some of the elements of targets or motivational hurdles. Budgets especially involve motivational, control, and performance evaluation considerations.

SCOPE OF STATEMENT

.10 This Statement provides guidance as to presentation and disclosure for those who choose to issue information about the future described as *financial forecasts.* Nothing herein should be interpreted to mean that the publication of financial forecasts is recommended or that a financial forecast is deemed to be a part of the basic financial statements.

.11 Financial projections, feasibility studies, budgets, plans, goals, and objectives are generally prepared for special purposes and do not fall within the scope of this Statement of Position; financial forecasts contained within a feasibility study do.

.12 Recommendations as to presentation and disclosure of cash flow or tax basis forecasts also do not fall within the scope of this Statement of Position.

RECOMMENDATIONS ON PRESENTATION AND DISCLOSURE

Format

.13 Financial forecasts preferably should be presented in the format of the historical financial statements[3] expected to be issued, but, at a minimum, the presentation should consist of certain specific information (see below) obtained from such a financial forecast.

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[3] The details of each statement may be summarized or condensed, so that only the major items in each are presented. The usual footnotes associated with historical financial statements need not be included as such. However, see *Assumptions,* pars. .19-.27, for additional comments.

.14 Financial forecasts presented in the format of the historical financial statements expected to be issued would facilitate comparisons with results experienced in prior periods and with results actually achieved in the forecast period(s). However, given the lack of experience of most enterprises in issuing financial forecasts, there is reason to consider, for the present, recommendations which would not unduly discourage the issuance of financial forecasts and which would permit experimentation in the development of communicative formats. Accordingly, when information described as a financial forecast is issued, it should include presentation of at least the following information (when applicable):

a. Sales or gross revenues.

b. Gross profit.

c. Provision for income taxes.

d. Net income.

e. Disposal of a segment of a business and extraordinary, unusual or infrequently occurring items.

f. Primary and fully diluted earnings per share data for each period presented.

g. Significant anticipated changes in financial position.

Accounting Principles

.15 Financial forecasts should be prepared on a basis consistent with the generally accepted accounting principles expected to be used in the historical financial statements covering the forecast period. This fact, as well as a summary of significant accounting policies, should be disclosed in the forecast. If a forecast is included in a document which contains such a summary, disclosure can be accomplished by cross-referencing.

.16 If the financial forecast gives effect to a change in accounting principle from one used in the historical financial statements of prior periods, the change should be reported in the forecast for the period in which it is expected to be made as would be required in reporting such accounting change in historical financial statements.

Expressing the Results

.17 Financial forecasts should be expressed in specific monetary amounts representing the single most probable forecasted result. The tentative nature of a financial forecast would be emphasized if the single most probable result for key measures (e. g., sales and net income) was supplemented by ranges or probabilistic statements, and the presentation of such information is encouraged.

.18 While a range informs the user of the probabilistic nature of the forecast, expressing a financial forecast *solely* in terms of ranges could result in the user's attributing an unwarranted degree of reliability to the forecast ranges, because many users might assume (a) that a range represented the spread between the best possible result and the worst possible result or (b) that the range was based on a scientifically determined interval. Management should be in the best position to determine the single most probable result, and this burden should not be placed on outsiders. Also, single point estimates are necessary to aggregate the forecasts of an enterprise's individual operations, as well as to facilitate comparison between the forecast and later historical results.

Assumptions

.19 Those assumptions should be disclosed which management thinks are most significant to the forecast or are key factors upon which the financial results of the enterprise depend. There ordinarily should be some indication of the basis or rationale for these assumptions. It would also be desirable for the disclosure to include an expression of the relative impact of a variation in the assumption when it would significantly affect the forecasted result.

.20 Frequently, basic assumptions that have enormous potential impact are considered to be implicit in the forecast. Examples might be conditions of peace, absence of natural disasters, etc. Such assumptions need be disclosed only when there is a reasonable possibility that the current conditions will not prevail. In such circumstances, to the extent practicable, the possible impact of a change in the assumptions should be disclosed.

.21 A financial forecast is based on assumptions representing management's judgment of the most likely circumstances and events and its most likely course of action. Assumptions are the single most important ingredient of a financial forecast. However, regardless of the amount of study or analysis, some assumptions inevitably will not materalize.

.22 There are several other factors with respect to the disclosure of assumptions which must be considered, particularly when the disclosures are external to the enterprise.

a. By nature, a financial forecast embodies a large number of assumptions, especially for a complex enterprise. An attempt to communicate "all" assumptions is inherently not feasible.
b. Outside users who disagree with one or more assumptions in a forecast are generally not able to adjust for the effect of these differences in assumptions on the forecast.
c. Questions may arise after the fact as to certain assumptions which were not disclosed. Unforeseen changes in conditions may make certain assumptions, previously considered unimportant, significant.

.23 Consideration of these factors does not change the previous conclusion that significant assumptions underlying a financial forecast should be disclosed.

.24 Disclosure of certain important information may not be desirable from the standpoint of the enterprise, particularly when competition or strategies are involved. While all significant assumptions should be disclosed, they need not be presented in such a manner or in such detail as would adversely affect the competitive position of the enterprise.

.25 Assumptions should be captioned in a manner which best reflects their nature, such as "Summary of Significant Forecast Assumptions." It should be made clear that the assumptions disclosed are not an all-inclusive list of those used in the preparation of the forecast and that they were based on circumstances and conditions existing at the time the forecast was prepared. Accordingly, the summary of assumptions should be preceded by an introduction similar to the following:

> This financial forecast is based on management's assumptions concerning future events and circumstances. The assumptions disclosed herein are those which management believes are significant to the forecast or are key factors upon which the financial results of the enterprise depend. Some assumptions inevitably will not materialize and unanticipated events and circumstances may occur subsequent to ...., the date of this forecast. Therefore, the actual results achieved during the forecast period will vary from the forecast and the variations may be material.

.26 Identifying those assumptions which, at the time of preparation, appear to be most significant to the forecast or which are key factors upon which the financial results of the business depend requires the careful exercise of good-faith judgment by management. The disclosures should include the following:

a. Assumptions as to which there is a reasonable possibility of the occurrence of a variation that may significantly affect the forecasted results.

b. Assumptions about anticipated conditions that are expected to be significantly different from current conditions, which are not otherwise reasonably apparent.

c. Other matters deemed important to the forecast or to the interpretation of the forecast.

.27 The following unrelated hypothetical examples of disclosures of assumptions are offered for general guidance:

a. The Company is engaged in several lines of business, two of which are defense-oriented and supplied X% and Y% of the Company's sales and gross profit, respectively, in 1974, as indicated on page — of the Annual Report to Stockholders. The Company's other lines of business are diversified.

   The sales forecast assumes, among other things, that revenue from the Company's federal defense contracts will continue at the current level and that non-defense sales will increase at the same rate as the anticipated increase in real GNP for 1975.

   If these conditions are not met, results may be significantly affected. For example, a decline of 5% from forecasted defense-oriented sales could result in a decline of approximately 8% in net income, while a decline of 5% from forecasted non-defense sales could result in a decline of approximately 6% in net income.

b. The Company expects its raw material costs to rise, on an overall basis, commensurate with the rate of inflation. The forecast assumes any raw material cost increases can be recovered in the form of higher prices. Labor costs have been forecasted using rates provided in the Company's union contract, which does not expire until 1976.

c. At certain times in the year, the Company is highly dependent on short-term bank borrowing. The Company's forecast of interest expense is based on the seasonal borrowing patterns of prior years for financing inventory and receivables. The Company does not expect to incur any long-term borrowing and anticipates no major changes in the prime rate from its present level of X%.

d. The provision for income taxes gives no effect to the possibility of a 6% decrease in the maximum corporate income tax rate, as proposed by the President in a message to Congress.

e. Manufacture of the Company's major products depends on the availability of relatively small quantities of petroleum by-products. The Company has no guaranteed source for these materials. The forecast assumes continued availability of these raw materials.

f. Earnings per share data have been computed following the same procedures used for historical financial statement purposes, which are in accordance with the provisions of APB Opinion No. 15. In calculations required by the "treasury stock" method, management has assumed, for such purposes, that there will be no significant changes in the price of the Company's stock.

Period to Be Covered

.28 Management should consider its ability to forecast and the needs of the user in determining the period to be covered. No fixed period of time is specified herein.

.29 Although the degree of uncertainty generally increases with the time span, short-term forecasts may not be meaningful in (a) industries with a lengthy operating cycle or (b) situations where long-term results are necessary to evaluate the investment consequences involved.

Distinguishing From Historical Financial Statements

.30 Financial forecasts should be presented separately (or clearly segregated) from the historical financial statements and should be clearly labeled as a "financial forecast" to preclude a reader from confusing a forecast with the historical financial statements.

.31 Applicable historical *information,* such as prior forecast data and prior historical results, may, however, be presented with any financial forecast in parallel columns. This would facilitate comparison and provide the user with information helpful in evaluating the risks associated with a financial forecast. When such historical information is presented, it should be clearly labeled and distinguished from the forecast information.

UPDATING FINANCIAL FORECASTS

.32 An updated financial forecast should be issued to reflect significant changes in assumptions, actual results, or unanticipated events and circumstances unless (a) the original forecast included a statement that it was not intended to be updated (see par. .36) or (b) issuance of historical financial statements covering the forecast period is imminent.

.33 An updated forecast should be issued if it can be done promptly. The reasons for updating should be described in a note to the updated forecast.

.34 When material changes in a forecast cannot be quantified so as to permit issuance of an updated forecast promptly, appropriate disclosure should be made. Such disclosure would include a description of the circumstances necessitating an updated forecast, and notification that the forecast should not be used for any purpose and that an updated financial forecast will be issued upon its completion.

.35 If, however, management decides that the current financial forecast should no longer be used for any purpose but it is not appropriate to issue an updated forecast, this decision and the reasons for it should be disclosed.

Forecasts Not Intended to Be Updated

36. Financial forecasts may be issued on a "one-time" basis, such as in connection with a search for debt or equity financing, without any intention to issue updated forecasts. In such cases, emphasis should be given to the date of issuance of the forecast and an explicit statement should be made as to the dangers inherent in using forecasts issued some time ago. In addition,

management's intention not to update the forecast should be specifically disclosed.

ACCOUNTING STANDARDS DIVISION

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Section 10,090

Statement of Position 75-5 Accounting Practices in the Broadcasting Industry

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Section 10,090

Statement of Position 75-5 Accounting Practices in the Broadcasting Industry

[Recommendation to Financial Accounting Standards Board]

AICPA American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

December 29, 1975

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying Statement of Position presents recommendations of the Accounting Standards Division on Accounting Practices in the Broadcasting Industry. It was prepared on behalf of the Division by the Accounting Standards Task Force on Entertainment Companies for consideration by the Financial Accounting Standards Board and for such action as the Board deems appropriate. The Division suggests that the recommendations contained herein be required to be applied in financial statements for fiscal years beginning on or after January 1, 1976 (or beginning in late December, 1975 for enterprises having fiscal years of 52 or 53 weeks).

The Statement discusses three areas of interest to broadcasters: television film license agreements, barter transactions and intangible assets.

The Statement concludes that assets and liabilities should be recorded for television film license agreements with respect to films available for telecasting. Guidelines are provided for the classification of these assets and liabilities. The film rights recorded as an asset should, it holds, be amortized using an accelerated method over the number of future showings estimated by management when the first showing, as is usually the case, is more valuable to a station than reruns. The Statement also takes the position that the provisions of APB Opinion No. 21 are applicable to television film license agreements.

Barter transactions involve the exchange of unsold advertising time for products or services. The Statement concludes that all barter transactions should be recorded by estimating the fair value of the product or service received, in accordance with the provisions of APB Opinion No. 29.

Finally, the Statement provides guidance with respect to the application of APB Opinion No. 17 to intangibles in the broadcasting industry, pending reconsideration by the FASB of the broad area of business combinations and purchased intangibles.

The Division would appreciate being advised as to the Board's proposed action on the recommendations set forth in this Statement of Position.

Sincerely yours,

Seymour M. Bohrer

SEYMOUR M. BOHRER
Chairman
Accounting Standards Task Force
on Entertainment Companies

cc: Securities and Exchange Commission

NOTES

Statements of Position of the Accounting Standards Division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of Statements of Position is to influence the development of accounting and reporting standards in directions the Division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, Statements of Position do not establish standards enforceable under the Institute's Code of Professional Ethics.

ACCOUNTING PRACTICES IN THE BROADCASTING INDUSTRY

GENERAL BACKGROUND

.01 The Federal Communications Commission (FCC) is responsible for the general regulation of television and radio broadcasters. Under current regulations, stations are licensed for three year periods to use assigned frequencies in specific locations. These frequencies are limited and are part of the public domain. The FCC has the authority to consider quality of programming, financial ability of station ownership, amounts of advertising, attention to community service and other factors in determining whether a license should be granted or renewed. The FCC does not, however, regulate rates. The National Association of Broadcasters has set forth guidelines with respect to the amount of advertising time which may be sold.

.02 Broadcasters derive revenue from national, regional and local advertisers. In addition, if a station is affiliated with a network it receives compensation for the network programming that it carries, based on a formula designed to compensate the station for commercial time sold on a network basis and included in network programming. Rates charged by stations vary considerably from market to market and within markets. The prices charged for advertising time are generally based upon the size and demographics of the estimated audience reached, which in turn depends on the size of the market and on the audience's acceptance of the station's programming. Station audiences are measured during rating periods to determine the size and demographic composition of the audiences reached. A station's selling prices (rate cards) are set by program or time periods, to reflect current audience ratings. Rate cards are revised periodically to reflect subsequent audience ratings and/or changes in economic conditions. While there is not always a direct relationship between revenues and expenses for a specific program, a station must maintain audience acceptance of its programming over a period of time or suffer a reduction in its rate schedule as compared to other stations in the market.

.03 Revenues are recognized when the station broadcasts the advertising the sponsor has contracted for. The networks report certain revenue information to their affiliates weekly and distribute that revenue monthly.

.04 Broadcasters may barter unsold advertising time for products or services. Such transactions permit the station to obtain something of value for time which might otherwise remain unsold. The station benefits, if bartering does not interfere with its cash sales, by exchanging otherwise unsold time for programs, fixed assets, merchandise, other media advertising privileges, travel and hotel arrangements, entertainment, and other services and products received from advertisers or agencies acting on their behalf.

.05 A major expense of a television station is its programming costs. These costs are substantially higher for an independent station than for a network affiliate because the affiliate does not incur programming costs for network showings and records only its network advertising revenue. The network recovers its programming costs through the sale of national advertising. Television stations include, however, many hours of non-network programming in their schedules. These programs, other than local news and interview shows and the like, are usually on video tape or film. They are generally contracted for under television license agreements and represent the largest element of programming expense for both network affiliated and independent stations.

.06 A broadcaster's principal intangible assets are its network affiliation agreement(s) and FCC license. Without an FCC license, it is impossible to earn revenue no matter how large the investment in equipment, people and programs. A network affiliated station is generally more valuable than an independent station in the same market because of network supplied programming and revenues. Network programming generally improves the audience levels during network and non-network programming periods. The improvement in audience levels tends to increase the rates and resultant revenue that a station receives from its national and local sales to advertisers.

.07 The Division has noted that there are variations in practice with respect to accounting by broadcasters, including networks, for certain transactions. This Statement of Position has been issued to narrow the range of acceptable alternative practices in the following areas:

- Accounting for television film rights and related license fees.
- Accounting for barter transactions.
- Accounting for network affiliation agreements and FCC licenses.

TELEVISION FILM LICENSE AGREEMENTS

Industry Practice

.08 Broadcast rights for feature length motion pictures, series produced for television, cartoons and other films are generally sold by producers or distributors to broadcasters for television exhibition under a contract which typically includes several films (a package) and permits one or more exhibitions of each film during specified license periods. (Certain licenses, however, permit unlimited showings during a specified period of time.) Fees stipulated in the agreement are usually payable in installments over a period of time which is generally shorter than the period of the licensing contract. The license expires after the last allowed telecast or at the end of the specified period even if the licensee telecasts a film less than the allowed number of times.

.09 Accounting practices with respect to film rights and related fees vary. The most common alternatives are summarized below:

1. The unpaid fees stipulated in the agreement are considered to be commitments, not liabilities, and neither the film rights nor the related fees are recorded in the balance sheet. Disclosure practices of companies following this alternative are not consistent.
2. Assets and liabilities are recorded for all television film license agreements. The liabilities are classified as current or noncurrent on the basis of the payment

terms specified in the agreement but the assets are classified in different ways:

(a) All film rights reported as current assets.

(b) All film rights reported as noncurrent assets.

(c) Film rights segregated between current and noncurrent based on—

(i) Availability for telecasting, or

(ii) Estimated usage within one year.

3. Assets and liabilities are recorded only with respect to those films which are currently available for telecasting. These assets and liabilities are classified in the balance sheet under one of the alternatives described in 2 above.

.10 Those broadcasters who record film rights as assets amortize those assets using one—or a combination—of the following methods:

1. Straight-line based on the period of the agreement.
2. Straight-line based on the number of showings specified in the agreement.
3. Straight-line based on the number of showings estimated by management.
4. Accelerated by assigning higher values to earlier showings, either based on the number of showings specified in the agreement or based on the number of showings estimated by management.
5. Accelerated by using the sum-of-the-years' digits, declining-balance, or variations of those methods.
6. Higher of (a) straight-line based on either the specified or estimated number of showings, or (b) straight-line over the contract period commencing with date of first showing.

.11 The provisions of APB Opinion No. 21, *Interest on Receivables and Payables,* are also not applied consistently to the receivables and payables arising from television film license agreements. Most film licensors impute interest on the receivable arising from the agreement. As a general rule, licensees do not impute interest on the payable. The Opinion is applicable to "receivables and payables which represent contractual rights to receive money or contractual obligations to pay money on fixed or determinable dates, whether or not there is any stated provision for interest. . . .'' The Opinion is not intended to apply to certain exempted transactions, but none of these exemptions is applicable to television film license agreements unless the receivables and payables arising from those agreements are "due in customary trade terms not exceeding approximately one year." In addition, those few broadcaster-licensees who do impute interest follow different methods:

1. Interest is imputed and expensed on all license agreements.
2. Interest is imputed and expensed only on those license agreements for films which are currently available for telecasting.
3. Interest is imputed on all license agreements but capitalized as additional costs of film rights.

.12 The practices which exist with respect to the recording of assets and liabilities under television film license agreements, the classification of any recorded assets and liabilities, the amortization of film license costs, and the application of APB Opinion No. 21, provide a broadcaster with the ability to select from a large number of combinations of alternative methods. The Division's conclusions with respect to these alternatives are summarized in the next section.

The Division's Conclusions

.13 The AICPA Industry Accounting Guide, *Accounting for Motion Picture Films,* specifies that a licensor should record a receivable and recognize income with respect to film license agreements at the commencement of the license period if all of the following conditions have been met:

1. The sales price for each film is known.
2. The cost of each film is known or reasonably determinable.
3. Collectibility of the full license fee is reasonably assured.
4. The film has been accepted by the licensee in accordance with the conditions of the license agreement.
5. The film is available; i. e., the right is deliverable by the licensor and exercisable by the licensee.

.14 The Division concludes that broadcasters' accounting should parallel the accounting by the licensor (although condition 3 above would not, of course, apply) and, accordingly, assets and liabilities should now be recorded in the accounts for the rights acquired and the obligations incurred under license agreements for those films available for telecasting.

.15 The assets should be segregated between current and noncurrent based on estimated usage within one year, and the liability should be segregated between current and noncurrent based on the payment terms specified in the license agreement. This is in accordance with generally accepted accounting principles as set forth in Accounting Research Bulletin No. 43, Chapter 3, Section A, and is also the predominant practice in the industry. The commitment for license agreements executed but not recorded because they are not currently available for telecasting should be disclosed in the notes to the financial statements.

.16 The Division believes that film rights should now be amortized based on the number of future showings estimated by management. This applies equally to licenses providing for limited showings and those with unlimited showings. Feature films should be amortized on an individual film basis. Film series and other syndicated products should be amortized on a series basis. Amortization of feature films on a film package basis may be appropriate if it approximates the amortization that would have been provided on a film-by-film basis. Licenses providing for unlimited showings of cartoons and films with similar characteristics may be amortized over the period of the agreement since this type of film may, in practice, actually be shown on an almost unlimited basis. Costs should be allocated to individual films within a film package on the basis of the relative value of each to the broadcaster.

.17 The Division has concluded that an accelerated method of amortization which takes into consideration the station's programming pattern is now required when the first showing, as is usually the case, is more valuable to a station than reruns. Accordingly, the straight-line method of amortization is only acceptable in those instances where each telecast is expected to generate similar revenues.

.18 Film costs should be carried in the balance sheet at the lower of unamortized cost or estimated net realizable value on a film-by-film, series, or package basis, as appropriate. Unamortized cost would normally not exceed estimated net realizable value; however, in those situations when management's expectations of the programming usefulness of a film, series or package are revised downward, it may be necessary to charge expense to reduce unamortized cost to estimated net realizable value. A write-down from unamortized cost to a lower estimated net realizable value establishes a new cost basis. Similar losses expected to arise from unrecorded television film license agreements should also be provided for by a charge to expense.

.19 Finally, the Division has also concluded that the provisions of APB Opinion No. 21 are applicable to television film license agreements and, accordingly, interest should now be imputed on the recorded liabilities and amortized as interest expense in conformity with paragraph 15 of the Opinion.

BARTER TRANSACTIONS

Industry Practice

.20 Present practices for recording barter revenue vary considerably, as indicated below:

1. Revenue and expense are not recognized for financial reporting purposes. (Memorandum records are usually maintained for FCC reporting purposes.)
2. Revenue is recorded when commercials are broadcast.
3. Revenue is recorded when merchandise or services are received.

.21 There is also a lack of uniformity in the methods of valuing the two sides of the transaction:

1. Fair value of merchandise or services received.
2. Retail value of merchandise or services received.
3. Value of commercial spots at standard ("rate card") rates.
4. Value of commercial spots at a discounted rate.

The Division's Conclusions

.22 The Division has concluded that all barter transactions should now be recorded by estimating the fair value of the product or service received, in accordance with the provisions of paragraph 25 of APB Opinion No. 29. Barter revenue should now be recorded when commercials are broadcast, and merchandise or services received should be recorded when received or utilized. If merchandise or services are received prior to the broadcast of the commercial, the deferred revenue should be recorded. Likewise, if the commercial is broadcast first, a receivable should be recorded.

.23 Television film license agreements, game shows and other programming, exclusive of network programming, obtained in exchange for a specified number of commercials should be valued at the fair value of the programming received.

.24 Barter revenue should be disclosed in the financial statements when it is material, in accordance with paragraph 28 of APB Opinion No. 29.

INTANGIBLE ASSETS

Industry Practice

.25 A network affiliation agreement and an FCC license are intangible assets frequently transferred to the buyer upon the purchase of a broadcasting station. An additional intangible asset arising upon the acquisition by purchase of a broadcasting station may be an excess of cost over the fair value of net identifiable tangible and intangible assets acquired (goodwill).

.26 Present practices with regard to the balance sheet presentation of these items and their amortization vary. Amounts allocated to network affiliation agreements, FCC licenses and goodwill are frequently presented by some companies as one amount and identified as "Intangibles," "Excess of Cost Over Underlying Net Assets Acquired," or other all-encompassing descriptions which frequently include the word "Goodwill." Other companies, however, segregate their intangible assets into components on the face of the balance sheet or in the notes thereto. Companies amortize these intangible assets in conformity with the requirements of APB Opinion No. 17 and generally use the maximum 40-year period for assets acquired after October 31, 1970, the effective date of APB Opinion No. 17. Intangible assets arising prior thereto are usually not amortized on the basis that there has been no diminution in value.

.27 The Institute of Broadcasting Financial Management, Inc., the financial management association of the broadcasting industry, and the National Association of Broadcasters have established a joint committee which has submitted a position paper to the Financial Accounting Standards Board on accounting for intangibles in the broadcasting industry.

.28 The joint committee believes that broadcasting intangibles have several characteristics which are shared with few, if any, other types of intangible assets, for the following reasons. First, broadcasting licenses and network affiliation contracts are identifiable assets which are granted under contractual terms having a virtually unlimited duration. Secondly, they have historically retained their original value and generally increased in value over a period of time. Third, the intangibles are marketable assets, inasmuch as they can be and frequently are sold, thus their value when compared to the sales of similar properties can be reasonably estimated.

.29 The joint committee's position paper requests that Accounting Principles Board Opinion No. 17 be modified by the Financial Accounting Standards Board, to provide that (1) the amortization or write-down of broadcasting licenses and network affiliation contracts be required only if their estimated value and future benefits are lower than their carrying value and (2) that the amortization or write-down of these assets below their residual value not be required. The joint committee acknowledges that a diminution in the value of these intangible assets should be recognized either through systematic amortization or write-offs as is warranted by the circumstances.

The Division's Conclusions

.30 The Division believes that the provisions of APB Opinion No. 17 apply to intangibles in the broadcasting industry as well as in other industries and should be followed, absent any action by the Financial Accounting Standards Board.

.31 APB Opinion No. 16, paragraph 68, requires that the cost of an acquisition be allocated to each individual asset acquired on the basis of its fair value. The individual assets are comprised of the tangible and identifiable intangible assets acquired. APB Opinion No. 17, paragraph 26, elaborates on this with the statement that "Cost should be assigned to all specifically identifiable assets; costs of identifiable assets should not be included in goodwill." Therefore, separate costs should be assigned to network affiliation agreements and any other identifiable intangible assets.

.32 The Division has concluded that when a network affiliation is terminated and not immediately replaced or under agreement to be replaced, the unamortized balance of the amount originally allocated to the network affiliation should be charged to expense. If a network affiliation is terminated and immediately replaced or under agreement to be replaced, and the fair value of the new network affiliation equals or exceeds the unamortized cost of the terminated affiliation, no gain should be recognized. However, a loss should be recognized to the extent that the unamortized cost of the terminated affiliation exceeds the fair value of the new affiliation.

.33 The amortization policy of the broadcaster should not be changed solely because there has been a change in the network with which the station is affiliated.

ACCOUNTING STANDARDS TASK FORCE ON ENTERTAINMENT COMPANIES

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Section 10,100

Statement of Position 75-6
Questions Concerning Profit Recognition on Sales of Real Estate

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Section 10,100

Statement of Position 75-6
Questions Concerning Profit Recognition on Sales of Real Estate

[Recommendation to Financial Accounting Standards Board]

AICPA

American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

December 29, 1975

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying Statement of Position has been prepared by the Accounting Standards Task Force on Real Estate Accounting to clarify the AICPA Industry Accounting Guide, Accounting for Profit Recognition on Sales of Real Estate.

Numerous questions have arisen in practice with respect to the application of the general principles and specific conclusions set forth in the Guide. Questions as to the applicability of the Guide to specific transactions and to companies other than real estate companies have also been raised. The Task Force has identified certain key questions and has recommended appropriate responses to them in this Statement of Position.

Members of the Task Force will be glad to meet with you or your representatives to discuss this proposal. The Task Force would also appreciate being advised as to the Board's proposed action on the recommendations set forth in this Statement of Position.

Sincerely yours,

Melvin Penner

MELVIN PENNER
Chairman
Accounting Standards Task Force
on Real Estate Accounting

cc: Securities and Exchange Commission

NOTES

The American Institute of Certified Public Accountants has issued a series of industry-oriented Audit Guides that present recommendations on auditing procedures and auditors' reports and in some instances on accounting principles, and a series of Accounting Guides that present recommendations on accounting principles. Based on experience in the application of these Guides, AICPA Task Forces may from time to time conclude that it is desirable to change a Guide. A Statement of Position is used to revise or clarify certain of the recommendations in the Guide to which it relates. A Statement of Position represents the considered judgment of the responsible AICPA Task Force.

To the extent that a Statement of Position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the Audit Guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the Task Force.

To the extent that a Statement of Position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the Task Force are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the Task Force believes would be in the public interest.

QUESTIONS CONCERNING PROFIT RECOGNITION ON SALES OF REAL ESTATE

BUYER'S INVESTMENT IN PURCHASED PROPERTY

Funds Provided (Loaned) by Seller

Question:

.01 With respect to paragraph 22 of the Guide,* what is the effect on the test of the adequacy of the down payment in a sale of real estate if the seller has made or will be making loans to the buyer builder/developer for acquisition, construction or development purposes? What is the effect of the existence of a permanent loan commitment by an independent third party?

Answer:

.02 Under paragraph 22, *any* funds that have been loaned or will be loaned, directly or indirectly, to the buyer by the seller must first be deducted from the down payment in determining whether the down payment test has been met. Paragraph 22 does not require that the funds loaned by the seller be specifically identified with the funds comprising the down payment. As an

* The paragraph and exhibit references are to appropriate sections of the AICPA Industry Accounting Guide, *Profit Recognition on Sales of Real Estate.*

example, if "A" sells unimproved land to "B" for $100,000, receives a down payment of $50,000 in cash, and plans to loan "B" $35,000 at some future date for installation of water and sewer lines, the down payment test has not been met. ($50,000 − $35,000 = $15,000 ÷ $100,000 = 15%; fails test as at least 20% is required.)

.03 Funds provided directly or indirectly by the seller include loan guarantees, collateral provided by the seller, and any other situation where the seller is subject to loss as a result of funds loaned to the buyer.

.04 Existence of a permanent loan commitment by an independent third party for replacement of the construction or development loan made by the seller does not eliminate the need to deduct the seller's loan from the down payment under paragraph 22. The Guide did not intend that consideration be given to such commitments and construction or development loans by the seller to the buyer must be deducted from the down payment whether or not a permanent loan commitment exists.

Acceptable Letters of Credit

Question:

.05 Paragraph 22 of the Guide requires that a buyer's down payment be composed of cash or notes supported by irrevocable letters of credit from an established lending institution. What constitutes an "established lending institution?" If the letters of credit are obtained subsequent to the period in which the transaction takes place but prior to the issuance of the financial statements, is it appropriate to include them for purposes of determining compliance with the down payment criteria in the earlier period?

Answer:

.06 An "established lending institution" refers to institutions, usually commercial banks, that issue letters of credit in the normal course of business.

.07 Buyer's notes, unless and until supported by irrevocable letters of credit covering the period of the notes, do not constitute cash equivalency (see paragraph 15) in a real estate transaction. Accordingly, the down payment criteria are not met for accounting purposes until the period in which letters of credit are obtained.

Cumulative Application of Tests when Recognition of Sale is Delayed

Question:

.08 Paragraph 27 of the Guide states that the "tests of adequacy of a buyer's initial and continuing investment . . . should be applied cumulatively—at the closing date and annually afterwards." What date should be used for the purpose of these tests when the transaction is not recorded as a sale for accounting purposes on the closing date and the proceeds are accounted for as a deposit?

Answer:

.09 The Guide indicates that under certain conditions the effective date of the sale for accounting purposes is required to be deferred (see paragraphs 9, 34, 35, 42, 45 and 54). When a transaction is recorded under the deposit method, the date from which the cumulative test would begin to apply would be delayed until the sale is recorded for accounting purposes.

Applicability of the Alternative 115% Test for Down Payment

Question:

.10 Does the alternative 115% test for down payment under paragraph 20 of the Guide apply if (a) the seller takes a receivable, collateralized by a first mortgage on the property sold, for the entire difference between the sales value and the down payment, or (b) if the buyer assumes, or takes the property subject to, a primary loan that is not a newly placed permanent loan for a portion of the difference between sales value and the down payment?

Answer:

.11 No. The 115% test for down payment in paragraph 20 does not apply if a newly placed permanent loan or firm loan commitment from an independent lender is not involved.

Down Payment Requirements on Single Family Residential Housing

Question:

.12 Footnote (b) to Exhibit A (minimum down payment requirement) calls for a higher down payment on sales of single family residential property if collectibility of the remaining portion of the sales price cannot be supported by reliable evidence of collection experience. Do the provisions of footnote (b) apply when independent first mortgage financing is utilized?

Answer:

.13 No. The provisions of footnote (b) are applicable when independent first mortgage financing is not utilized and the seller takes a receivable from the buyer for the difference between the sales value and the down payment. When independent first mortgage financing is utilized, the minimum down payment on sales of single family residential property should be determined in accordance with paragraph 20 of the Guide.

SELLER'S CONTINUED INVOLVEMENT WITH PROPERTY SOLD

Time of Sale Considerations

Question:

.14 Are paragraphs 47-48 and 60 of the Guide in conflict with the closing requirements in paragraph 14 of the Guide? Paragraphs 47-48 and 60 permit income recognition during a development or construction phase assuming all other conditions of the Guide are met. On the other hand, paragraph 14 includes as a prerequisite to income recognition the criterion that ". . . all conditions precedent to closing have been performed." One major condition precedent to closing on such properties as buildings, condominiums, etc., is that the structure be ready or certified for occupancy. Which of these paragraphs prevails? If an exception to paragraph 14 is intended with respect to completion, then are exceptions intended with respect to any other requirements of paragraph 14?

Answer:

.15 Because of the length of the construction period of office buildings, condominiums (especially high rise), shopping centers and similar structures (excluding single family homes), the Guide was written to permit income recognition during the process of construction even though the fact of completion is usually a "condition precedent," and thus this exception to paragraph 14 is an exception to this condition only.

Calculation of Safety Factor

Question:

.16 In applying Exhibit C, paragraph 55 of the Guide states "that estimated rent receipts should be reduced by a safety factor of 33⅓% unless signed lease agreements have been obtained to support a projection higher than the rental level thus computed." Should the 33⅓% reduction be applied to the *total* estimated future rent receipts (including the amount resulting from signed lease agreements) or only to the estimated future rent receipts which are not yet subject to signed lease agreements?

Answer:

.17 The 33⅓% reduction should be applied to the *total* estimated future rent receipts for each period unless the amount so computed is less than the actual amount of rent receipts resulting from signed lease agreements. In this event, the actual amount would be substituted for the computed amount.

.18 As an example, "A" sells an office building under development to "B" together with an agreement to support operations of property for a period of three years. The projected annual rent roll is $1,000,000, of which $350,000 is supported by signed lease agreements. The *projected* rental income for the first year of operation of the office building is $600,000, the second year $750,000 and the third year $1,000,000. *At the time of sale,* the amounts includible in the Exhibit C calculation would be computed as follows:

Year	Projected Rental Income	Safety Factor (33⅓%)	Adjusted Projected Rental Income
1	$ 600,000	$200,000	$400,000
2	750,000	250,000	500,000
3	1,000,000	333,333	666,667

.19 In the example, if at the time of sale there were signed lease agreements in the amount of $450,000, then the $450,000 would be used in year 1 since it is greater than the adjusted projected rental income. The adjusted projected rental income for years 2 and 3 would remain $500,000 and $666,667, respectively.

Sales of Condominiums

Question:

.20 Paragraph 60 of the Guide with respect to sales of condominium units states that "profit should not be recognized . . . unless construction is beyond a preliminary stage, the buyer is committed to the extent of being unable to require a refund, sufficient units have already been sold to assure that the property will not revert to rental property, and aggregate sales proceeds can be estimated reasonably." What do each of the above criteria for profit recognition mean?

Answer:

Construction Is Beyond a Preliminary Stage

.21 Actual construction of buildings usually must be preceded by engineering and design work, execution of construction contracts, site clearance and preparation, excavation and completion of the building foundation. Ordinarily, if any one of these required phases is incomplete, the work is not beyond a preliminary stage.

The Buyer Is Committed to the Extent of Being Unable to Require a Refund

.22 The buyer cannot have the right under the terms of the agreement or by law to receive a refund, except for nondelivery of the unit. Examples where a sales contract may not be binding and therefore voidable may include but are not limited to the following:

- Certain states require a minimum status of completion of the project.
- Certain states require that a "Declaration of Condominimum" be filed. (In some states, however, the filing of the declaration is a routine matter and the lack of such filing may not make the sales contract voidable.)
- Some sales contracts include a provision that permanent financing at an acceptable cost must be available to the buyer at the time of closing.
- Certain condominium units must be registered with either the Office of Interstate Land Sales Registration of the Department of Housing and Urban Development or the Securities and Exchange Commission.

Sufficient Units Have Already Been Sold to Assure that the Property Will Not Revert to Rental Property

.23 In determining whether or not this condition has been met, the following should be considered:

- Economic conditions.
- Developer's history.
- State laws may require that a specified percent of units be sold.
- Sales contract may provide buyer with right of rescission until a specified percent of units are sold.
- Seller may retain right to convert to rental basis.
- Construction loans may require that a specified percent of units be sold before the lender will release any units.
- End loan financing commitments may provide that a specified percent of units be sold before closing of any sale.

.24 The Guide intended to preclude recognition of profit on sales of condominium units which can later be rescinded because the *entire* property reverts to a rental project. Technically, this provision of the Guide may be satisfied when the number of units sold meets the requirements of the state law (or relevant jurisdiction), the condominium contract and the financing agreement, so that such sales are not legally voidable either by the buyer or the seller. Nevertheless, there is a presumption that at least 50% of the individual units should be sold before any profit is recognized on the percentage of completion method. The reason for this presumption is that profit attributed to units sold may not be subject to reliable estimates until a substantial number of units are sold, because of uncertainties concerning either the ultimate number and sales value of units to be sold (see below) or the costs to be incurred.

Aggregate Sales Proceeds Can Be Reasonably Estimated

.25 Consideration should be given to sales volume, trends of unit prices, developer's experience, geographical location and environmental factors. Sometimes certain units in a condominium project are difficult to sell, indicating that the pricing structure may not reflect realizable sales value. For example, certain units may have been designed in a manner that does not reflect changes in market demand, or certain units may not be as desirable as others because of location or aesthetic factors. In these cases, consideration should be given to the possibility that some of the remaining units may not be sold or may have to be sold at substantially reduced prices.

APPLICABILITY OF THE GUIDE

Applicability to Companies Other Than Real Estate Companies

Question:

.26 Paragraph 3 states that the Guide was prepared to appraise accounting practices in the real estate industry. Are the principles in the Guide applicable to manufacturing, distribution and other companies which are not real estate companies?

Answer:

.27 Yes. The Guide was meant to apply to all sales of real estate, except retail lot sales covered by the AICPA Industry Accounting Guide, *Accounting for Retail Land Sales,* without regard to the nature of the seller's business.

Sale of Corporate Stock

Question:

.28 The Guide primarily covers the timing of profit recognition on real estate sales. Does the Guide apply to the sale of corporate stock of a company with substantial real estate?

Answer:

.29 If the sale is in economic substance a sale of real estate, provisions of the Guide would apply.

Sale of Partnership Interests

Question:

.30 The Guide contains provisions for the timing of profit recognition if a person sells to a limited partnership in which the seller is the general partner. Is the Guide applicable if a person forms a partnership, arranges for the partnership to acquire the property directly from third parties, and sells a portion of his interest in the partnership to persons who then become limited partners?

Answer:

.31 The Guide is applicable. In particular see paragraphs 57 to 59 of the Guide with respect to partial sales.

Sale of an Option

Question:

.32 The Guide primarily covers the timing of profit recognition on real estate sales. Does the Guide apply to the sale of options to purchase real estate?

Answer:

.33 Yes. Sale of such an option is a sale of an interest in real estate and, accordingly, the principles in the Guide apply.

.34 For purposes of evaluating the buyer's commitment when an option is sold by an option holder, the initial and continuing investment by the buyer of the option (which would exclude amounts which are subject to refund by the seller) should be related to the total of the exercise price of the option and the sales price of the option. For example, if the option is sold for $150,000, ($50,000 cash and a $100,000 note) and the exercise price is $500,000, the sales value against which the buyer's down payment and continuing investment is measured is $650,000. If the buyer's investment is inadequate, income may be recorded on the cost recovery method to the extent non-refundable cash proceeds exceed the seller's cost of the option.

.35 Proceeds from the issuance of a real estate option by a property owner should be accounted for as a deposit as set forth under paragraph 35 of the Guide. It is not appropriate to recognize income before the option either expires or is exercised because the sale of the option cannot be evaluated independently from the sale of the real estate to which the option relates. If the option is exercised, cash proceeds from the issuance of the option should be accounted for as a down payment and included in sales value.

ACCOUNTING STANDARDS TASK FORCE ON REAL ESTATE ACCOUNTING

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Section 10,110

Statement of Position 76-1 Accounting Practices in the Record and Music Industry

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Section 10,110

Statement of Position 76-1 Accounting Practices in the Record and Music Industry

[Recommendation to Financial Accounting Standards Board]

AICPA

American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

August 25, 1976

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying Statement of Position presents recommendations of the Accounting Standards Division on Accounting Practices in the Record and Music Industry. It was prepared on behalf of the Division by the Accounting Standards Task Force on Entertainment Companies for consideration by the Financial Accounting Standards Board and for such action as the Board deems appropriate.

The Statement discusses several areas where different accounting practices exist in the record and music industry: revenue recognition, inventory valuation, compensation of artists, costs of record masters, licensor income and licensee cost, and intangible assets acquired in a business combination.

The Statement's major recommendations are briefly summarized below:

- Manufacturers and distributors in the record and music industry must be able to make a reasonable estimate of returns in order to account for shipments to customers as sales.

- The valuation of inventories in this industry should be similar to that of any other manufacturing concern and thus these inventories, including returned records, should be carried at the lower of cost or market.

- When the past performance of an artist provides a reasonable basis for estimating that advances to that artist and the cost of a record master for that artist will be recoverable, such amounts should be recorded as assets.

- In most cases, licensors should record minimum guarantees as deferred income to be amortized ratably over the performance period. However, when a license agreement is, in substance, an outright sale it should be accounted for as such. Licensees should record minimum guarantees as deferred charges to be expensed in accordance with the terms of the agreement.

The Division would appreciate being advised as to the Board's proposed action on the recommendations set forth in this Statement of Position.

Sincerely yours,

Seymour M. Bohrer

Seymour M. Bohrer
Chairman
Accounting Standards Task Force
on Entertainment Companies

cc: Securities and Exchange Commission

ACCOUNTING PRACTICES IN THE RECORD AND MUSIC INDUSTRY

GENERAL BACKGROUND

Record Manufacturing

General Description

.01 The record industry consists of numerous entities, from small operations to substantial divisions of large companies. It has certain unique characteristics. First, success in it depends to a large extent on acceptance by the public of the creative efforts of third-party composers and performers. Since such acceptance is frequently of very short duration, there is a need for prompt saturation of the marketplace to maximize revenues. (Classical and other music which has achieved sustained public acceptance are exceptions to this general rule.) Second, a relatively high portion of the manufacturer's costs consists of royalties or fees which are generally, but not always, based on net sales.

.02 A record manufacturer normally enters into a contractual arrangement (a) with the artist (performer) and possibly with a producer to record a given number of selections over a specified period of time, or (b) with a production company to deliver finished record masters of one or more artists. The phonograph discs and tapes (hereinafter referred to collectively as "records") are then manufactured and shipped for ultimate sale to the customer. The manufacturer may own or be affiliated with the pressing plant, the tape duplicator, the distributor and the retailer, or with some or none of these.

.03 The manufacturer will usually grant licenses for the sale or distribution of its products to record clubs and other direct mail operations and, for sales throughout the world, to one or more companies active in the industry in foreign countries. Again, the manufacturer may own or be affiliated with all, some or none of the licensees.

The Record Master

.04 A performance is initially recorded on magnetic tape. Usually, each musical instrument and voice is recorded separately and then re-recorded to emphasize or deemphasize each sound in the final product. Such a process, called mixing, is performed by an expert sound engineer to produce a master tape, which is the "record master." The record master, in turn, is used to produce an acetate disc which is subsequently coated with metal and used to produce the molds or stampers used in commercial record production. In addition, the record master is used to make other tapes from which commercial tape cartridges, cassettes and reels may be produced.

.05 The costs of producing a record master include (1) cost of the musical talent (musicians, vocal background and arranging), (2) cost of the technical talent for engineering, directing and mixing, (3) costs for the use of the equipment to record and produce the master, and (4) studio facility charges.

Marketing

.06 Marketing in the record and music industry currently includes the following levels of distribution:

- Manufacturers, as discussed above, contract with artists for the recording of selections, arrange and finance the actual recording and provide for the pressing of records and duplication of tapes or sheet music. Manufacturers generally sell to distributors, wholesale merchandisers and record clubs.
- Distributors usually sell the products of a limited number of manufacturers to wholesale merchandisers, record stores and other retail outlets.
- Wholesale merchandisers, sometimes called subdistributors or rack jobbers, function as service agencies for the music departments of chain stores and other retail outlets by supervising individual store in-

ventories, selecting titles and labels, determining quantities to be ordered, and sometimes developing advertising and promotional programs. Wholesale merchandisers usually sell the products of a variety of manufacturers and the services they provide are not normally offered by the distributor.

- Retail outlets purchase from the aforementioned suppliers and sell directly to the ultimate customer. Retail outlets include record stores, the music departments of chain and discount stores, and record clubs.
- Record clubs came into existence in the 1950's and serve as a direct line from the record manufacturer to the ultimate customer. Record clubs, including those operated by a manufacturer, commonly distribute the records of more than one manufacturer and normally offer a number of "free" records (records given free of charge or at a nominal price) as an inducement to join, subject to the new member's agreeing to purchase a certain number of records at or near retail list prices.
- Compilation records are normally manufactured from masters embodying recordings of one or more artists by one or more record manufacturers. They include more than the usual number of selections per record, are sold at prices below those charged for the original records, and are generally offered through television and radio advertising. The customer may purchase the record through the mail or directly from a designated retail outlet.

Recording Artist Contracts

.07 As stated previously, a record manufacturer employs artists under personal service contracts. The major portion of artist compensation consists of a participation (measured by sales and license fee income and commonly referred to as a "royalty") and/or a non-refundable advance against royalties based upon contractual terms negotiated between the parties. The artist may agree to bear a portion or all of the costs of the record master and the manufacturer may then recoup that amount from artist royalties otherwise payable. The extent of such arrangements depends on the relative bargaining strength of each party. However, such advances and costs are generally not recoupable from the artist if royalties do not cover them.

.08 Generally, in connection with recordings made in the United States, payments are also made to various union funds under contractual arrangements which measure the obligation on the basis of sales activity. Such payments are usually not made with respect to recordings of foreign artists made in studios outside the United States.

Music Publishing

General Description

.09 The music itself, as opposed to a given recording, is normally controlled by a music publisher. Publishers are sometimes controlled by a record manufacturer, but in many instances publishers are either affiliates of the artist/composer or independent.

.10 The publisher normally obtains the rights to music from composers with the objective of exploiting the music for its maximum revenue. At one time, most music publishers were small, independent entities. Lately, however, there have been two trends: one toward merger with and ownership by record manufacturers, the other toward ownership by composers, who in many cases are recording artists as well.

.11 The publisher's two prime sources of revenue are royalties from record companies and royalties from public performances for profit. Other sources include revenue from the use of music in motion pictures and from the sale of sheet music.

Royalties

.12 Copyright royalties to publishers are based on the U. S. Copyright Law, but the requirements of the law are normally modified by licenses issued by the publishers. By statute, royalties to publishers are due monthly at $.02 per selection based on quantities manufactured, whereas licenses often provide for quarterly accountings at stipulated rates (which are sometimes less than $.02) based on quantities sold. Substantial changes in the Copyright Law have been suggested and a new Act has been introduced in the last several sessions of Congress which may, if enacted, materially affect royalties. If copyrights have not been obtained or have expired, the music is in the public domain and no royalties are payable.

.13 Music publishers are normally affiliated with a collection society for collection of public performance revenue, either

ASCAP (American Society of Composers, Authors and Publishers) or BMI (Broadcast Music, Inc.). These societies collect from television and radio stations, the primary source of public performance revenue, as well as from other sources, such as live performances. Stations may supply these societies with broadcasting logs and may be monitored on a test basis. By formula and allocation, the societies determine revenue for each selection and normally pay both publishers and composers their shares directly.

.14 Music publishers in most instances have another organization act as their agent for licensing record companies and other users, collecting royalties and verifying the accuracy of the royalties paid. Publishers may sell their own sheet music or may license others to do so for a royalty.

.15 Foreign income arises from the same sources (broadcasting, live performances, sheet music, etc.). However, U. S. publishers normally grant foreign publishers exclusive rights in specific territories for varying percentages of the revenue earned in the territory.

.16 The music publishers, in turn, normally pay composers a share of the royalty receipts (excluding performance income which is usually paid directly by the collection society) and a flat rate per unit in the case of sheet music.

REVENUE RECOGNITION

Industry Practice

.17 The timing of revenue recognition and the determination of the amount of revenue to be reported for a given period of time can be an accounting problem because of the right of return that normally accompanies sales in the record and music industry.[1] These return rights can vary from unlimited to a percentage of sales, or may be in the form of exchange privileges which permit the customer to receive other records for those returned. Regardless of the form of arrangement between supplier and customer, sales are generally made with the right of return or exchange, subject to time limits that the manufacturer may establish, such as when the specific record is deleted from its catalog. These return or exchange practices have been established by manufacturers to induce customers to

[1] Although the discussion which follows deals solely with records, similar practices and problems are found in the printed music industry; see paragraphs .52 and .53.

carry larger inventories than they might otherwise maintain in an industry subject to volatile swings in consumer preferences. In addition, when a manufacturer changes a distributor, it is customary to permit the former distributor to return all of the manufacturer's records for credit.

.18 It is the predominent practice in the industry to record sales when inventory is shipped and where the customer is obligated to pay for the merchandise in accordance with normal trade terms.

.19 Some manufacturers discount the price of records by including a number of "free" records in certain shipments. Credits issued for returned records give recognition to such "free" records either by using the average selling price or by reducing the total units returned in proportion to the number of "free" records included in the original shipment.

.20 Because of the return or exchange privilege, manufacturers and distributors usually make a provision in their financial statements for the anticipated return of records from current and prior sales. The resultant allowance for returns is usually combined with the allowance for doubtful accounts and deducted from trade receivables in the balance sheet. In the income statement, the provision for returns is generally netted against gross sales recorded for the period, but is sometimes classified as "sales returns and allowances." However, in some cases the sales transaction is reversed and an inventory is established. In other cases a liability is accrued for the return privilege. The determination of the amount of anticipated returns is based on many factors, including historical experience, popularity of the music recorded, success of the recording artists, marketing techniques, etc.

.21 Some manufacturers and distributors (who have return privileges with manufacturers) do not provide in their financial statements for return privileges granted to their customers and recognize losses, if any, arising from returns only when they are incurred.

The Division's Conclusion

.22 The question of revenue recognition when right of return exists has been discussed in Statement of Position No. 75-1 [section 10,050] of the Accounting Standards Division of the AICPA. That Statement holds that "... If the seller is exposed to the risks of ownership through return of the property, it should be presumed that the transactions should not be recognized currently as sales unless *all* of the following conditions are met. . . ." These conditions and their applicability to the record and music industry are discussed below:

"(1) The seller's price to the buyer is substantially fixed or determinable at the date of exchange."

> Sales prices are normally fixed at the date of exchange in the record and music industry.

"(2) Either the buyer has made full payment, or the buyer is indebted to the seller and payment is not contractually or implicitly excused until such time as the product is resold."

> Payment for merchandise in the record and music industry is usually required within thirty days under the terms of sale, or, in the case of deferred billing, within sixty to ninety days of shipment.

"(3) The buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the property."

> The risk of loss with respect to record and music merchandise is transferred to the buyer under usual trade practices upon transfer of physical possession of the merchandise.

"(4) The buyer acquiring for resale has economic substance apart from that provided by the seller; that is, the buyer is not a straw party or a conduit."

> It would not be common to find a buyer who is a straw party or a conduit in the record and music industry.

"(5) The seller does not have significant obligations for future performance to bring about resale of the property by the buyer."

> The seller would not normally undertake obligations to bring about resale of the property by the buyer in this industry.

"(6) The amount of future returns can be reasonably predicted."

> Predicting the amount of future returns in the record and music industry can be difficult, as indicated below.

.23 Although each of the conditions listed above must be met and the usual conditions for recording sales not involving the right of return must also be satisfied, the sixth condition is usually the most troublesome.

.24 The Statement of Position acknowledges that the "ability to make a reasonable prediction of the amount of future returns is dependent on the existence of many factors," and that "only general guidelines can be established." It lists five factors which "would appear to impair the ability to make a reasonable prediction," all of which must be considered; however, the factor that requires the most consideration in the record and music industry is the following:

> "Absence of historical experience with similar types of sales of similar types of property, or inability to apply such experience because of changing circumstances."

.25 Rates of return in the record and music industry vary from company to company and from year to year and very little information is published regarding returns. High volume and reasonably stable rates of return have enabled many established companies to make a reasonable estimate of returns on the basis of their own historical and forecasting experience. However, companies expanding to a different type of music (classical, jazz, rock, etc.) and companies engaging a large number of unproven artists, among others, may not possess sufficient experience of their own on which to make a reasonable estimate of future returns. In those instances, or where a company is new and has no historical experience, reference to the experience of other enterprises, if such experience is applicable and obtained in sufficient detail, may provide useful information in determining a reasonable estimate of returns.

.26 The Division believes that manufacturers and distributors in the record and music industry must be able to make a reasonable estimate of returns in order to account for shipments to customers as sales. This conclusion is consistent with the provisions of paragraph 23 of FASB Statement No. 5 with respect to uncollectible receivables.

.27 Certain types of music may be susceptible to dramatic swings in popularity; artists may have no prior experience and uncertain futures; the market for certain types of music may be monopolized by a few artists; distribution channels may be narrow and promotional endeavors limited; and the quantity of returns may be large when a manufacturer changes a distributor. All of these conditions create difficulty in making a reasonable estimate of the amount of future returns. When the presence of such conditions precludes a manufacturer or distributor from making a reasonable estimate of the amount of future returns, the transaction should not be recognized currently as sales. Transactions for which sales recognition is postponed should be recognized as sales when the return privilege has substantially expired.

.28 As required by Statement of Position No. 75-1 [section 10,050] amounts of sales revenues and cost of sales reported in the income statement should exclude the portion for which returns are expected and, because sales returns are a significant factor in determining the results of operations in the record and music industry, the amount of gross sales and the related accounting policies should be disclosed.

INVENTORY VALUATION

Industry Practice

.29 Inventory valuation in the record and music industry is difficult because of the severe obsolescence problem resulting from changing consumer tastes and return or exchange practices. This problem is even more pronounced when the inventory valuation of returned records is being determined. For this reason, some companies assign no value to returned records. Others carry them at estimated salvage value, cost, or the lower of cost or market. The valuation policy may depend on whether the records are singles, LP albums or tapes. In addition, the determination of market value is complicated by the existence of two markets: one for the resale of records on a marked-down basis, and another for the scrap value of the physical components.

The Division's Conclusion

.30 The valuation of inventories in this industry should be similar to that of any other manufacturing concern. Inventories should be carried at the lower of cost or market.[2] Inventories of salable records and inventories of records to be scrapped should be separately valued. The market value of records to be scrapped should be their expected net salvage value. Although manufacturing cost is usually minor relative to the selling price of most records, cost may exceed market value when drastic reductions to selling price have been made.

COMPENSATION OF ARTISTS

Industry Practice

.31 As noted elsewhere in this Statement, artists are usually compensated on a royalty basis; the royalty provisions are set

[2] See ARB No. 43, Chapter 4, for guidance.

forth in the artist's contract and may vary substantially among artists, since they depend on the artist's bargaining power.

.32 Generally, the total amount of royalty accrued (adjusted for anticipated returns) is charged to expense in the period in which the sale of the record takes place. However, the accounting for advances paid to artists which are recoupable (recoverable) out of future royalties is not consistent among companies. The common alternatives are summarized below:

(1) The advance is recorded as an asset with subsequent royalties earned offset against it until the advance has been fully recovered or determined to be unrecoverable. Some believe this method achieves the best matching of revenue and expense.

(2) The advance is recorded as an asset but expensed when the record is released. Some believe this is a practical method to achieve a reasonable matching of revenue and expense, since the bulk of record revenues are received in a relatively short period of time.

(3) The advance is recorded as expense when paid by those who emphasize the difficulty of predicting the sales and returns of a *particular* record.

(4) The advance is included as part of inventory cost by those who believe that such advances are another element of the cost of producing a record and should be amortized on the same basis as any other recording cost.

The Division's Conclusion

.33 The Division believes that advances should be recorded as an asset (a prepaid royalty, current or noncurrent, as appropriate) when the past performance of the artist to whom the advance is made provides a reasonable basis for estimating that it will be recouped (recovered from future royalties). The advance should be charged to income as subsequent royalties are earned by the artist. However, it is a generally accepted accounting principle that losses should be provided for when they become evident. Therefore, as soon as it is estimated that all or a portion of the unrecouped advance will not be recovered from future royalties earned by the artist, that portion of the advance should be charged to expense.

.34 Management should evaluate the artist's past performance, the success of the particular release, market trends, contractual or other arrangements, and other pertinent information in determining whether the advance is recoverable. The right to recoup advances from a number of records of an artist may complicate the recoverability determination. However, failure to recover a proportionate amount of the advances from royalties payable on each release would normally establish a presumption that at least a portion of the advance should be written off.

.35 Commitments for artist advances payable in future years and future royalty guarantees should now be disclosed in a note to the financial statements, if material, and evaluated currently to determine if a loss provision is required.

.36 Inasmuch as artist royalties, as well as copyright and other royalties, are generally a significant cost, a careful review of the contracts and possible interpretations thereof is essential to a determination of an appropriate accrual.

COSTS OF RECORD MASTERS

Industry Practice

.37 Under the standard type of artist contract, the cost of producing a record master can be separated into costs borne by the record company and costs recoverable from artists out of designated royalties earned. Typically, the stronger party to the contract bears a lesser portion of the costs; the more successful artists often do not bear any of the costs of record masters. On the other hand, recoupment of costs recoverable from the artist is usually not limited to royalties on a specific record.

.38 The portion of the costs of a record master recoverable from artists is accounted for as a royalty advance using one of the methods discussed in the section on "Compensation of Artists."

.39 Several methods are employed to account for record master costs borne by the record company:

(1) Record the cost of the record master as an asset and amortize it on the income forecast method. Advocates of this approach believe that it achieves an appropriate matching of income and expense.

(2) Defer the cost of the record master and charge it to expense in the period of the record's initial release. Supporters of this approach believe that it is a practical method to achieve a reasonable matching of revenues and expense. Since the bulk of record revenues are derived within the first six months of release, they believe this method matches costs with revenues unless the release is near the end of an accounting period.

(3) Expense the cost of the record master when incurred. Those who believe this approach is appropriate point out the difficulty of predicting the sales of a *particular* record.

(4) Include the cost of the record master as part of inventory cost. Those who prefer this alternative believe that the cost of a record master is another element of the cost of producing a record and should be amortized on the same basis as any other *recording cost.*

The Division's Conclusion

.40 The Division believes that when the past performance of an artist provides a reasonable basis for estimating that the cost of a record master borne by the record company will be recovered from future sales, that cost should be recorded as an asset and, when material, that asset should be separately disclosed. The cost of record masters should be amortized using a method that reasonably relates the cost of the record master to the net revenue expected to be realized. The Division believes that records, other than those of classical and other music which has achieved sustained public acceptance, have a very short life and costs relating thereto should be amortized accordingly. The portion of the costs recoverable from the artist's royalties should be accounted for as discussed in the preceding section on "Compensation of Artists."

LICENSOR INCOME AND LICENSEE COST

Industry Practice

.41 As noted in a previous section of this Statement, substantial revenues may be realized by the owner of a record master or copyright by licensing it to third parties. Minimum guarantees are usually paid in advance by the licensee. Additional payments are normally required if license fees based on actual sales exceed the minimum guarantee.

Licensors treat such guarantees as either:

(1) Revenue when received.

(2) An advance, allocated ratably over the period covered by the guarantee.

(3) Revenue to the extent of the portion earned during the reporting period, reflecting unearned balances, if any, as income at the expiration of the period covered by the license agreement.

.42 Licensees treat minimum guarantees as costs using similar methods.

.43 When no minimum guarantee is received, or when actual license fees exceed the minimum guarantee, revenue is not normally recognized by the licensor until an accounting is received from the licensee.

.44 In certain situations, other fees may be required under the license agreement. For example, further payments may be required from a record club if it ships "free" records in a quantity which exceeds a specified percentage of sales of the licensor's records over the term of the agreement. Such fees have generally been recorded as revenue by the licensor and as expense by the licensee upon expiration of the agreement.

The Division's Conclusion

.45 The Division believes that in most cases licensors should record minimum guarantees as deferred income to be amortized ratably over the performance period, which is generally the period covered by the license agreement. License agreements for the use of records and music (unlike those, for example, for television exhibition of motion picture films) normally do not specify the total amount of the license fee. Also, the licensor normally has an obligation to furnish music or record masters during the license period. Ratable amortization is appropriate because in many cases it is impossible for the licensor to ascertain whether the actual amount of license income earned under the terms of the agreement exceeds a ratable portion of the minimum guarantee. (This is particularly true with respect to foreign licensees, who frequently do not render accountings on a timely basis.) However, when the licensor can determine that license fees earned under the agreement exceed a ratable portion of the minimum guarantee, it is appropriate to record that greater amount in income.

.46 In some cases, however, a license agreement may, in substance, be an outright sale. When the licensor has signed a noncancellable contract, has agreed to a specified fee, has delivered the rights to the licensee who is free to exercise them, and has no remaining significant obligations to furnish music or records, the earnings process is complete and the fee may be recorded as revenue when collectibility of the full fee is reasonably assured. In such circumstances, neither the licensee's use of the rights transferred nor the passage of time during the license period has any significance in relation to the recognition of revenue by the licensor.

.47 The licensee should record minimum guarantees as a deferred charge which should be expensed in accordance with the terms of the agreement. However, as soon as it is estimated that all or a portion of the minimum guarantee will not be recovered through future use of the rights obtained under the license, that portion of the minimum guarantee should be charged to expense.

.48 The Division believes the licensor should not recognize in revenue the other fees (e. g., those for excess "free" records) discussed previously under "Industry Practice" until the agreement has expired and the amount is fixed and determinable. Prior to the expiration date of the agreement, the licensor normally would have no information as to the number of "free" records distributed. In addition, an estimate of income based on such information, if available, would be contingent on future events. However, the licensee should provide for such expenses on a license-by-license basis for each period covered by the respective financial statements.

.49 Appropriate consideration should be given to matching artist royalties and other costs to recognition of revenue from licensees.

INTANGIBLE ASSETS ACQUIRED IN A BUSINESS COMBINATION

.50 The acquisition of a record manufacturer or music publisher in a business combination accounted for as a purchase normally entails, among other things, the acquisition of various intangible rights and assets such as record masters, unexpired artist contracts and copyrights. These rights and assets are normally specifically identifiable and have determinable lives and, therefore, should be recorded in accordance with APB Opinion No. 17, paragraphs 24 to 26.

.51 An allocation of the purchase price should be made for financial statement purposes in accordance with APB Opinion No. 16, paragraph 68, based on fair value. (Experience indicates that in many cases no material amount of goodwill results from such allocations.) Appropriate amortization over the useful life (as opposed to the legal life) of each such type of asset should be provided. The benefits expected to be received from such intangible assets may follow an irregular pattern during the estimated lives of those assets. When this is the case, the Division believes that a method of amortization that reasonably relates the cost of such assets to the net revenue (benefits) expected to be realized is more appropriate than the straight-line method.

MUSIC PUBLISHERS

.52 The problems, practices and recommendations discussed elsewhere in this Statement are applicable to music publishers, where appropriate.

.53 However, the Division recognizes that all or substantially all of a music publisher's revenues are from licensees. The determination of revenue may be difficult since reports from licensees, particularly those in foreign countries, are often delayed. The Division believes that revenue for a period should include reasonable estimates of revenue from each material license for the full period.

ACCOUNTING STANDARDS TASK FORCE ON ENTERTAINMENT COMPANIES

Section 10,120

Statement of Position 76-2 Accounting for Origination Costs and Loan and Commitment Fees in the Mortgage Banking Industry

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Section 10,120

Statement of Position 76-2 Accounting for Origination Costs and Loan and Commitment Fees in the Mortgage Banking Industry

[Recommendation to the Financial Accounting Standards Board]

AICPA American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

August 25, 1976

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying Statement of Position presents recommendations of the Accounting Standards Division on Accounting for Origination Costs and Loan and Commitment Fees in the Mortgage Banking Industry. It was prepared on behalf of the Division by the Accounting Standards Executive Committee for consideration by the Financial Accounting Standards Board and for such action as the Board deems appropriate. The accounting principles recommended herein are applicable to mortgage banking companies and to divisions of commercial banks and other financial institutions that originate and service loans for other than their own account.

The Statement takes the position that the deferral of any costs of originating mortgage loans in-house (including warehousing and/or marketing costs) should no longer be considered acceptable. However, a portion of the purchase price of certain bulk purchases should be deferred as the cost of the right to receive future servicing revenue. The cost equivalent to one month's interest incurred upon issuance of GNMA securities using the internal reserve method should also be deferred. In each of these cases, according to the Statement, the aggregate amount deferred should not exceed the present value of the amount of future servicing revenue reduced by the present value of expected servicing costs. It is suggested that it is more appropriate to amortize such deferred costs in proportion to the estimated net servicing income from the related mortgage loans.

A mortgage banker can also obtain contractual rights to receive future servicing revenue by acquiring other mortgage banking companies or by acquiring selected servicing contracts. The Statement discusses the appropriate accounting in these circumstances.

The Statement also identifies several different types of loan and commitment fees and suggests appropriate accounting for such fees. In general, these recommendations defer income recognition to a greater extent than is usual in present practice.

The Division would appreciate being advised as to the Board's proposed action on the recommendations set forth in this Statement of Position.

Sincerely yours,

Raymond C. Lauver

Raymond C. Lauver
Chairman
Accounting Standards Division

cc: Securities and Exchange Commission

NOTES

Statements of Position of the Accounting Standards Division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of Statements of Position is to influence the development of accounting and reporting standards in directions the Division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, Statements of Position do not establish standards enforceable under the Institute's Code of Professional Ethics.

ACCOUNTING FOR ORIGINATION COSTS AND LOAN AND COMMITMENT FEES IN THE MORTGAGE BANKING INDUSTRY

INTRODUCTION

.01 The Accounting Standards Division of the American Institute of Certified Public Accountants issued a Statement of Position on *Accounting Practices in the Mortgage Banking Industry* on December 30, 1974 (Statement of Position No. 74-12 [section 10,040]) outlining the Division's position on mortgage banker accounting for inventory of permanent mortgage loans held for sale and certain other accounting matters. The Division has also noted that mortgage bankers use a variety of practices to account for loan origination costs and loan and commitment fees and believes that it is desirable to narrow the range of those practices.

.02 The Division's recommendations with respect to accounting for origination costs and loan and commitment fees, as set forth herein, are applicable to financial statements of mortgage bankers that are intended to present financial position, results of operations or changes in financial position in conformity with generally accepted accounting principles. In addition, certain commercial banks and other financial institutions have divisions which conduct operations that are very similar to those performed by mortgage bankers; when such divisions originate and service loans for other than their own account, the accounting principles recommended in this Statement should be followed.

MORTGAGE BANKING OPERATIONS

.03 Mortgage bankers originate, market and service real estate mortgage loans by bringing potential borrowers and investors together. They originate real estate mortgage loans in order to increase their servicing portfolio and the related servicing income. Many mortgage bankers engage in other related operations, including insurance brokerage, property management, real estate development and sales, management of real estate investment trusts, joint venture investments, and construction lending for residential and commercial development. Mortgage bankers acquire mortgage loans for sale to permanent investors from a variety of sources, including applications received directly from borrowers (in-house originations), purchases from realtors and brokers, purchases from investors and conversions of various forms of interim and construction financing. The mortgage loans are sold to a variety of permanent investors, including insurance companies, pension funds, savings banks, the Federal National Mortgage Association (FNMA), and since 1970 have been placed in trusts to collateralize Mortgage Backed Securities (MBS) guaranteed by the Government National Mortgage Association (GNMA).

.04 Mortgage bankers often originate permanent *residential* loans (one to four family dwellings) without specific commitments from permanent investors to purchase such loans. Since the amount of a typical residential loan is relatively small, mortgage bankers normally obtain block commitments from investors for large dollar amounts of residential loans meeting broad general criteria. However, permanent *commercial* loans are usually large in amount and require careful underwriting and, normally, mortgage bankers will not issue commitments for commercial loans without first obtaining investors' commitments to purchase the specific loans.

.05 Many mortgage bankers solicit land acquisition, development, and construction loans. Mortgage bankers became active in such lending in order to increase their volume of originations of real estate mortgage loans and many, because of the relatively high interest rates associated with such loans, found this activity profitable. These loans generally require the borrower to repay the loan at or shortly after completion of development or construction and, consequently, are usually relatively short-term, seldom exceeding three years.

.06 Mortgage bankers usually retain the right to service the permanent loans which they originate and sell to investors. The loans being serviced are called a loan servicing portfolio. Loan servicing includes, among other functions, collecting monthly mortgagor payments; forwarding payments and related accounting reports to investors; collecting escrow deposits for the payment of mortgagor property taxes and insurance; and paying taxes and insurance from escrow funds when due. The mortgage banker receives a servicing fee, usually based on a percentage of the outstanding principal balance of the loan, for performing these servicing functions. When servicing fees exceed the costs of performing servicing functions the existing contractual rights associated with a servicing portfolio have an economic value, and portions or all of such servicing portfolios have frequently been purchased and sold.

.07 Mortgage bankers have traditionally sold their originated loans individually or in relatively small blocks to a variety of different investors. Recently, however, a growing volume of mortgages have been placed in trusts to collateralize mortgage-backed securities guaranteed by GNMA. Payments to GNMA security holders are made on either the concurrent dates (15 day) method or the internal reserve (45 day) method. When mortgage bankers use the internal reserve method, a cost equivalent to one month's interest, which may be partially recovered in future periods, is incurred upon issuance of the security. There is no such cost associated with securities issued under the concurrent dates method.

ORIGINATION COSTS

Background

.08 Costs of originating mortgage loans in-house include (1) direct personnel expenses, (2) other direct costs, and (3) general and administrative expenses such as occupancy, equipment rental, etc. Mortgage bankers may incur expenses at both home office and branch locations for the purpose of originating loans. Certain of these expenses, such as commissions paid to loan originators, may vary proportionately with origination activity, while other expenses may be more fixed in nature. Some mortgage bankers have indicated that origination fees are adequate to cover direct origination costs; others, particularly those who believe general and administrative and certain other expenses should be allocated to origination activities, disagree. Identification of the costs of originating specific loans is difficult, and many mortgage bankers do not believe it is necessary to maintain the records required to identify such specific loan costs.

.09 Many mortgage bankers, however, have incurred in-house origination costs in excess of the revenue derived from their origination operations. They originate such loans in order to obtain the increase in servicing revenue resulting from selling the loans to investors while retaining the loans in their servicing portfolio.

.10 Mortgage bankers, in addition to originating mortgage loans in-house, use other methods to increase their servicing portfolios. One method is to acquire, from other companies, existing contractual rights to service specific mortgage loans for investors. This has been accomplished both by acquiring selected servicing contracts and by acquiring other mortgage banking companies. A portion or all of the price has often been allocated both to the right to receive future servicing revenue and to the relationship with new investors, to whom the mortgage banker may more readily sell future mortgage loans because of the servicing relationship. The amortization of the amount allocated to the right to receive future servicing revenue is deductible for income tax purposes while the amount allocated to the relationship with new investors is not.

.11 Another method used to increase servicing portfolios is to make bulk purchases of mortgage loans from governmental agencies, particularly GNMA, and from FNMA and other mortgage companies. Some of these bulk purchases are made only after contracts for sale of the related mortgage-backed security or of the mortgage loans themselves have been negotiated by the mortgage banker with permanent investors. Others are made on a "market risk" basis; that is, the loans are marketed on the same basis as loans originated in-house. Mortgage bankers may enter into these transactions even when they estimate that the costs of the mortgage loans will exceed the subsequent selling prices in order to obtain the future servicing revenue. Such bulk purchases have been fairly rare. However, many mortgage bankers expect GNMA and FNMA to continue to conduct auctions of their mortgages and, therefore, mortgage bankers may make more purchases from FNMA and governmental agencies in the future.

Costs of Originating Mortgage Loans In-House

Current Industry Practice

.12 Under present practices followed by most mortgage bankers for both financial reporting and income tax purposes, all revenue and costs associated with the origination of mortgage loans in-house are reflected in current operations; however, a few companies have begun to defer some of these costs on the basis that such costs were incurred to obtain the related future servicing revenue. The components of origination costs deferred vary from company to company. Some companies consider the origination function completed once a loan is funded by the mortgage banker, while others also include the income and costs associated with the warehousing and/or marketing functions in deferred origination costs.

The Division's Position

.13 In view of (1) the long-standing practice followed by mortgage bankers of expensing costs of originating mortgage loans in-house as incurred, (2) the fact that mortgage bankers receive origination fees as at least partial reimbursement of in-house origination costs, (3) the difficulty in identifying the costs of originating specific loans, and (4) the practice followed by other industries with similar activities (costs are reflected in current operations), the Division believes that the deferral of any costs of originating mortgage loans in-house (including warehousing and/or marketing costs) should no longer be considered acceptable.

Bulk Purchases and Sales of Mortgage Loans

Current Industry Practice

.14 Generally, the revenues and costs associated with the purchase and sale of mortgage loans have been recorded in current operations by mortgage bankers. However, because of the large dollar amounts and because of the similarities to the purchase of servicing contracts (see paragraphs .10 and .18 to .24), many mortgage bankers have treated a portion of the purchase price of bulk purchases of mortgage loans from governmental agencies, particularly GNMA, and from FNMA and other mortgage companies as the cost of acquiring rights to receive future servicing revenue and have deferred such amounts. The portion of the purchase price allocated to these rights has usually been the difference between the total purchase price, including any transfer fees, and either the eventual sales price of the loans or the market value of the loans at the date of purchase. Some mortgage bankers have also deferred processing costs associated with purchasing and selling the loans and any interest spread between the loan rate and their borrowing rate for warehousing the loans during their holding period. All amounts deferred have been amortized to future operations.

The Division's Position

.15 The Division believes that a portion of the purchase price of certain bulk purchases (usually only purchases from FNMA and GNMA and other governmental agencies) should be deferred as the cost of acquiring rights to receive future servicing revenue associated with the purchased loans when the mortgage banker retains the right to service such loans. The amount deferred should not exceed the excess of the purchase price of the loans, including any transfer fees paid, over the market value of the loans at the date of purchase,[1] subject to the following limitations and conditions:

(a) At the time the transaction is initiated, there should exist a definitive plan for the sale of the mortgage loans or related mortgage-backed securities. This plan should include estimates of purchase price and selling price with reasonable support for such estimates. A definitive plan is deemed to exist when the mortgage banker (1) has, previous to the date of the bulk purchase, obtained commitments from permanent investors to purchase the mortgage loans or mortgage-backed securities or (2) enters into a commitment within a reasonable period of time (usually not more than thirty days after the date of the bulk purchase) to sell the mortgage loans or mortgage-backed securities to an investor or underwriter.

(b) The amount deferred should be reduced by any excess of the final sales price to the permanent investor over the market value of the loans at the date of the bulk purchase. The purpose of this requirement is to preclude the deferral of any amount recovered at the date of sale through the sales price.

(c) No costs associated with the transactions other than those identified above (excess of purchase price, including transfer fees, over market value as defined) should be deferred. Therefore, interest, salary, and general and administrative expenses, for example, should specifically *not* be deferred.

[1] See the Division's Statement of Position No. 74-12 [section 10,040] for guidelines as to the computation of market value.

(d) The amount deferred should not exceed the present value of the amount of net future servicing income, determined in accordance with the provisions of paragraph .25.

(e) No amounts arising from transactions with other mortgage bankers should be deferred unless such purchases from other mortgage bankers are rare and unusual and not in the ordinary course of business. The purpose of this requirement is to preclude the capitalization, through such transactions, of in-house origination costs that should be charged to current operations.

Cost Incurred Upon Issuance of Certain GNMA Mortgage-Backed Securities

Current Industry Practice

.16 The cost equivalent to one month's interest incurred upon issuance of GNMA securities using the internal reserve method has been expensed by some companies. It has been deferred and amortized by others, on the basis that this cost was incurred to secure future mortgage servicing revenue and might be partially recovered in future periods.

The Division's Position

.17 The Division believes that the one month's interest cost incurred upon issuance of GNMA securities using the internal reserve method should be deferred and amortized. The aggregate amount deferred (including amounts deferred under other provisions of this Statement of Position) should not exceed the present value of the future net servicing income as determined in accordance with the recommendations in paragraph .25.

Costs of Purchasing Existing Contractual Rights to Service Mortgage Loans

Current Industry Practice

.18 As discussed in paragraph .10, a mortgage banker may acquire contractual rights to service mortgage loans (i. e., the right to receive future servicing revenue) from other mortgage bankers by acquiring selected servicing contracts or by acquiring the assets or the outstanding stock of the selling company. APB Opinions No. 16 and No. 17 provide guidance as to the appropriate accounting for the costs of the intangible assets resulting from the acquisition of such contractual rights, both those acquired separately and those acquired in connection with a business combination. The costs have often been allocated both to the right to receive future servicing revenue and to the relationship with new investors; such costs have been deferred and amortized to operations over future periods. In business combinations, amounts may also be recorded as goodwill.

.19 The costs allocated to the right to receive future servicing revenue have usually been calculated based upon at least some of the factors mentioned in paragraph .25. The amounts deferred have generally been amortized over the estimated remaining lives of the loans. Costs allocated to the relationship with new investors have usually been amortized over a forty-year period, in conformity with APB Opinion No. 17, since they were presumed to have an indeterminate life.

.20 Amounts recorded as goodwill in connection with business combinations initiated after October 31, 1970, have been accounted for in conformity with APB Opinions No. 16 and No. 17.

The Division's Position

.21 APB Opinions No. 16 and No. 17 provide guidelines for accounting for business combinations and for intangible assets; it is not the intention of this Statement of Position to modify the provisions of those Opinions.

Servicing Contracts Acquired in a Business Combination

.22 The Division believes that the right to receive future servicing revenue is an intangible asset of the type discussed in APB Opinion No. 17 and that an allocation of the purchase price to that right is appropriate. In no event, however, should the amount allocated to such a right exceed the present value of the future net servicing income, calculated in accordance with the recommendations in paragraph .25.

.23 When the purchase price includes amounts paid for other intangible assets, those assets should be accounted for in accordance with the applicable provisions of APB Opinions No. 16 and No. 17. One such asset might be a relationship with a new investor. The Division believes, however, that the value of such a relationship in the mortgage banking industry usually cannot be determined, for the following reasons. Although a relationship with a new investor may facilitate future sales to that investor, generally that new investor makes no specific commitment to purchase additional loans from the mortgage banker and the mortgage banker is not assured of any future sales. Absent such sales, the relationship has, of course, no value. Furthermore, even when the investor agrees to an exclusive territorial relationship with the mortgage banker, the Division believes it is usually not possible to make a reasonable estimate of the volume or price of future loan originations and the amount of the related future servicing revenue.

Servicing Contracts Acquired In Other Circumstances

.24 When contractual rights to service mortgage loans are acquired other than by a business combination, the Division believes that an allocation of the purchase price should first be made to the right to receive future servicing revenue. This amount should not exceed the present value of the future net servicing income, calculated in accordance with the recommendations in paragraph .25. Any excess of the purchase price over the amount allocated to the right to receive future servicing revenue should be accounted for in accordance with the applicable provisions of APB Opinion No. 17.

Limitation on Amounts to be Deferred

.25 Amounts deferred in accordance with paragraphs .15, .17, .22 and .24 that are associated with the right to receive future servicing revenue should not exceed the present value of the amount of future servicing revenue reduced by the present value of expected servicing costs. The estimates of future servicing revenue should include probable late charges and other ancillary income. Servicing costs should include direct costs associated with performing the servicing functions associated with the acquired contractual rights and appropriate allocations of other costs.[2] The rate used to calculate the present value should be an appropriate current interest rate.[3]

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[2] Reference should be made to the Mortgage Bankers Association of America, Inc., suggested chart of accounts for guidance as to the types of revenues and costs to be included. In this connection, the Division believes that servicing costs may be calculated on an incremental cost basis.

[3] The use of an appropriate current interest rate is in accordance with APB Opinion No. 16, paragraph 88. Since servicing income will be recognized over a period of several years, the Division believes that a long-term rate is the most appropriate interest rate to use in calculating the present value of such servicing income.

Amortization of Deferred Costs

Current Industry Practice

.26 The two methods currently used for amortizing deferred costs associated with future servicing revenue are the straight-line and the accelerated methods. Although servicing revenue (other than late charges and certain other related ancillary income) is generally reflected in operations based on a fixed percentage of the unpaid principal balances of the mortgages, a substantial number of mortgage bankers amortize related deferred costs on the straight-line method. Most mortgage bankers using an accelerated amortization method have chosen the sum-of-the-years' digits method. Deferred costs associated with future servicing revenue are usually amortized over the estimated average remaining lives of the related mortgage loans.

The Division's Position

.27 The Division recommends that any deferred costs of rights to receive future servicing revenue and any deferred costs equivalent to one month's interest incurred upon issuance of GNMA mortgage-backed securities using the internal reserve method be amortized in proportion to the estimated net servicing income from the related mortgage loans, because this method relates the amortization to the benefits expected to be received (see paragraph .25). For that reason, the Division believes that the method described is more appropriate than the straight-line method in the mortgage banking industry.

.28 It should be noted that deferred costs are to be amortized over the period of *net servicing income* rather than the period of the *servicing revenue*, since the period estimated to be benefited by the deferred costs is the period of net servicing income.

LOAN AND COMMITMENT FEES

Background

.29 Mortgage bankers frequently charge borrowers fees in addition to the interest charges on the funds advanced. While the types of fees charged may vary and are limited only by the imagination of borrowers and lenders, loan fees can be identified as one or more of the following:

(a) A fee which in reality is an adjustment of the interest rate.

(b) A fee received as compensation to the lender for earmarking funds so that they will be available to the borrower when required. Maintaining such funds in a liquid position may result in a lower yield than could be realized absent the need for liquidity. Also, the lender may need available lines of credit to call upon to honor his commitments, and various costs are normally incurred to maintain such available credit.

(c) A fee received to guarantee the borrower an interest rate at or near the market rate at the time the commitment is issued. The fee is charged to compensate the lender for taking the risk that the market rate of interest for the individual borrower when the loan is funded will be higher than the commitment rate.

(d) A fee to compensate the lender for underwriting and processing the loan.

(e) A fee received to provide a construction lender with assurance that he will be repaid. Such fees are frequently called "standby" or "gap" commitment fees. The related loan commitments are usually not expected to be funded. "Standby" commitments are normally issued to enable the borrower to obtain construction loans from a lender who is unwilling to provide such financing without the protection of a commitment for permanent financing which will repay the construction loan. Such commitments normally provide for an interest rate substantially above the market rate in effect at the time of issuance of the commitment. Commitment fees may also relate to the issuance of a commitment to loan funds to cover possible cost overruns or to provide intermediate term "gap" financing while the borrower is in the process of satisfying provisions of the permanent financing agreement, such as obtaining designated occupancy levels on an apartment project.

(f) A fee received for performing other services.

.30 In addition to collecting fees, mortgage bankers often pay fees to obtain commitments from permanent investors to purchase mortgage loans from the mortgage banker.

.31 Mortgage bankers have followed a number of methods for recognition of income from loan fees, including the following:

(a) Immediate recognition upon receipt

(b) Deferral with amortization—

 (1) over the commitment period

 (2) over the combined commitment and loan period

 (3) over the loan period

(c) Deferral without amortization with recognition in operations when it is clear that the commitment will not be funded

(d) Deferral until loan is repaid or sold.

The Division's Position

.32 The terminology applied by mortgage bankers to the fees which they receive varies widely. The selection of the most appropriate treatment for a loan fee should be based not on its descriptive title but on an analysis of the nature and substance of the related transaction. The Division believes that all fees received by mortgage bankers as a result of their loan origination activities should be accounted for in accordance with the recommendations in the following paragraphs.

.33 The Division believes that loan fees collected by mortgage bankers generally represent compensation for a combination of services and may include, for example, an adjustment of the interest rate on the loan, a fee for earmarking funds, and/or an offset of underwriting costs. The Division also believes it is not practicable to separate a loan fee into its components and, therefore, recommends that such fees be accounted for in accordance with their primary purpose as outlined below.

(a) Residential Loan Origination Fees—

Mortgage bankers usually collect origination fees for residential loan originations. The Division believes that the normal residential origination fee is essentially a reimbursement for the costs of the underwriting process of obtaining appraisals, processing the loan application, reviewing legal title to the real estate, and other procedures. The Division believes such fees, to the extent they are a reimbursement for such costs, should be recognized in income as they are collected, since the costs of these services are charged to expense as incurred. Any fees in excess of this amount should be treated as commitment fees. Since the identification of origination costs is extremely difficult (see paragraph .08), the Division believes that fees in an amount not in excess of the allowable FHA and VA rates may be recorded as income at loan closing, because fees based on such rates will generally not exceed origination costs.

(b) Residential Loan Commitment Fees—

In addition to the origination fees, mortgage bankers often charge a commitment fee to the borrower or to a builder/developer to guarantee the funding of loans. In addition, the mortgage banker often pays commitment fees to permanent investors to ensure the ultimate sale of the funded loans. Normally these commitment fees (both received and paid) relate to blocks of loans for a specified total dollar amount. The Division believes that both the commitment fees paid and those received should be deferred. They should be recognized in operations upon completion of the sale of the loans to the permanent investor or when it is evident that the commitment will not be used. If the commitment fees paid or received relate to a commitment amount for a block of loans, the portion of the fees recognized in operations as the result of an individual loan transaction should be based on the ratio of the individual loan amount to the total commitment amount.

(c) Commercial Loan Placement Fees—

Mortgage bankers may receive fees for arranging a commitment directly between a lender and a borrower. Additionally, mortgage bankers sometimes issue commitments in their own name which contain clauses making the loan funding contingent upon simultaneous funding of the loan by a permanent investor. The Division believes that if the mortgage banker has obtained a commitment from an investor prior to making his own commitment, and if his own commitment to the borrower requires simultaneous assignment to and funding by the investor, the transaction is in substance a loan placement transaction. In transactions of either of these types, the Division believes that the mortgage banker is serving only as a conduit between lender and borrower and the fees received should be recognized in operations when the mortgage banker has no remaining significant obligations for performance in connection with the transaction.

(d) Commercial Loan Commitment Fees—

Commitments to fund a loan on an income-producing or commercial property frequently have longer terms than those associated with residential loans. The fees from such commitments generally involve larger dollar amounts and they vary more widely as a percentage of the loan amount than residential loan fees. The Division believes that commitment fees received and paid in connection with a commercial permanent loan should be deferred and recognized in income upon completion of the sale of the loan to the permanent investor.

(e) Land Acquisition, Development, and Construction Loan Fees—

The Division believes that such loan fees should be deferred and recognized as income over the combined commitment and loan period. The straight-line method of amortization should be used until funding begins; the interest method should be used for the remaining unamortized balance during the loan period. The commitment and loan period of a construction or development loan is directly related to the length of the construction or development period, which is affected by many variable factors. The best estimate of such period should be utilized. In the event of a significant revision to the original estimate of the period, the unamortized portion of the commitment fee at the time of revising the estimate should be amortized ratably over the revised period. Any subsequent fees collected as a result of changes in the period should likewise be amortized over the revised period.

(f) Standby and Gap Commitment Fees—

The Division believes that because the potentially volatile nature of the market for real estate loans may require the funding of standby and gap commitments, fees for such commitments should be recognized as income over the combination of the commitment and standby or gap loan period. The straight-line method of amortization should be used during the commitment period and the interest method should be used for the remaining unamortized balance during the loan period if the loan is funded. Any additional fees collected at the time of funding the loan should be amortized over the loan period.

(g) Fees for Services Rendered—

In some cases mortgage bankers will collect fees solely for providing services with respect to the origination of a loan, such as appraisals, etc. The Division believes that such fees should be recognized in operations when the services have been performed.

.34 In recognizing loan fees as income, consideration must be given to the collectibility of the fee. If the fee has not been received in cash, there must be evidence that its collectibility is reasonably assured.

.35 When commitments expire without being funded or loans are repaid prior to the estimated repayment date, the Division believes any unamortized loan fees should be recognized in operations at that time.

ACCOUNTING STANDARDS DIVISION

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Accounting Standards

Section 10,130

Statement of Position 76-3 Accounting Practices for Certain Employee Stock Ownership Plans

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Section 10,130

Statement of Position 76-3
Accounting Practices for Certain Employee Stock Ownership Plans

[Recommendation to the Financial Accounting Standards Board]

AICPA

American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

December 20, 1976

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying Statement of Position presents recommendations of the Accounting Standards Division on Accounting Practices for Certain Employee Stock Ownership Plans (ESOPs). It was prepared on behalf of the Division by the Accounting Standards Executive Committee for consideration by the Financial Accounting Standards Board and for such action as the Board deems appropriate.

The Statement deals primarily with accounting and reporting issues that have arisen with respect to those ESOPs that borrow funds from a bank or other lender to acquire shares of stock in the employer company or that issue notes to existing shareholders in exchange for shares of stock. However, certain conclusions in the Statement are also applicable to ESOPs that have not entered into such transactions.

The Statement's major recommendations are briefly summarized below:

- An obligation of an ESOP should be recorded as a liability in the financial statements of the employer when the obligation is covered by either a guarantee of the employer or a commitment by the employer to make future contributions to the ESOP sufficient to meet the debt service requirements.

- The offsetting debit to the liability recorded by the employer should be accounted for as a reduction of shareholders' equity.

- The liability recorded by the employer and the offsetting debit should both be reduced as the ESOP makes payments on the debt.

- The amount contributed or committed to be contributed to an ESOP with respect to a given year should be charged to expense by the employer; the compensation and interest elements of the contribution should be separately reported.

- All shares held by an ESOP should be treated as outstanding shares in the determination of earnings per share. Dividends paid on those shares should be charged to retained earnings.

- Any additional investment tax credit should be accounted for as a reduction of income tax expense in the year in which the contribution to the ESOP is charged to expense.

The Division would appreciate being advised as to the Board's proposed action on the recommendations set forth in this Statement of Position.

Sincerely yours,

Raymond C. Lauver

Raymond C. Lauver
Chairman
Accounting Standards Division

cc: Securities and Exchange Commission

NOTES

Statements of Position of the Accounting Standards Division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of Statements of Position is to influence the development of accounting and reporting standards in directions the Division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, Statements of Position do not establish standards enforceable under the Institute's Code of Professional Ethics.

ACCOUNTING PRACTICES FOR CERTAIN EMPLOYEE STOCK OWNERSHIP PLANS

INTRODUCTION

.01 The Employee Retirement Income Security Act of 1974 describes an Employee Stock Ownership Plan (ESOP) as a qualified stock bonus plan, or a combination stock bonus and money purchase pension plan, designed to invest primarily in "qualifying employer securities."[1] Qualifying employer securities include the employer's stock and its other marketable obligations. The essential differences between an ESOP and other qualified stock bonus plans are that (a) an ESOP is permitted, in certain circumstances, to incur liabilities in the acquisition of employer securities and (b) the employer may be permitted to increase his maximum allowable investment tax credit by as much as an additional 1½% if that amount is contributed to an ESOP.

.02 In some cases, funds are borrowed from a bank or other lender by the ESOP and are used to acquire shares of stock in the employer company. The stock may be outstanding shares, treasury shares, or newly issued shares, and is held by the ESOP until it is distributed to the employees. (In some cases, an ESOP may issue notes to existing shareholders in exchange for qualifying employer securities.) The stock may be allocated to individual employees even though it may not be distributed to them until a future date. The debt of the ESOP is usually collateralized by a pledge of the stock and by either a guarantee of the employer or a commitment by the employer to make

[1] Employee Retirement Income Security Act of 1974, Title II, Subtitle B, Section 2003.

future contributions to the ESOP sufficient to meet the debt service requirements. The employer company makes annual contributions to the ESOP that are deductible for tax purposes, subject to the limitations of the Internal Revenue Code. Cash contributions and dividends received are used by the ESOP to:

(a) Satisfy the annual amortization of the outstanding debt principal.

(b) Satisfy the annual interest costs on such debt.

(c) Obtain short-term investments to provide for liquidity.

(d) Pay other expenses.

(e) Acquire additional shares of the employer company's stock, to the extent of the excess, if any, over that required by (a) through (d) above.

.03 Several accounting and reporting issues have arisen with respect to those ESOPs that borrow funds from a bank or other lender to acquire shares of stock in the employer company, or that issue notes to existing shareholders in exchange for shares of stock.[2] These issues are being dealt with in practice in different ways. This Statement of Position has been issued because the Division believes it is desirable to narrow the range of alternative accounting practices in this area.

.04 Final regulations clarifying the rights and duties of the parties affected by an ESOP have not been issued by the Internal Revenue Service. Readers of this Statement of Position should also be cognizant of the content of such regulations, when they are issued.

ACCOUNTING FOR AN OBLIGATION OF AN ESOP GUARANTEED BY THE EMPLOYER

Recording an ESOP's Obligation in the Employer's Financial Statements

.05 The Division believes that an obligation of an ESOP should be recorded as a liability in the financial statements of the employer when the obligation is covered by either a guarantee of the employer or a commitment by the employer to make future contributions to the ESOP sufficient to meet the

[2] This Statement of Position does not deal directly with ESOPs that might invest in qualifying employer securities other than equity securities.

debt service requirements. The employer's guarantee or commitment is, in substance, the assumption of the ESOP's debt and the related obligation to reduce that debt. The employer has assumed these obligations either (a) to buy back its own shares (in the case where the ESOP uses the loan proceeds to acquire previously outstanding shares) or (b) to finance additional working capital or other fund needs (in the case where the ESOP uses the loan proceeds to acquire previously unissued or treasury shares from the employer).

.06 It does not follow from the above that assets held by an ESOP should be included in the financial statements of the employer. Ownership of these assets rests in the employees, not in the employer.

Recording the Offsetting Debit to the Recorded Liability

.07 The Division believes that the offsetting debit to the liability recorded by the employer should be accounted for as a reduction of shareholders' equity. Therefore, when new shares are issued to the ESOP by the employer, an increase in shareholders' equity should be reported only as the debt that financed that increase is reduced. (The offsetting debit in shareholders' equity in this case is akin to the unearned compensation discussed in APB Opinion No. 25, paragraph 14.) When outstanding shares, as opposed to unissued shares, are acquired by the ESOP, shareholders' equity should similarly be reduced by the offsetting debit until the debt is repaid.

Reducing the Recorded Liability

.08 The Division believes that the liability recorded by the employer should be reduced as the ESOP makes payments on the debt. The liability is initially recorded because the guarantee or commitment is in substance the employer's debt. Therefore, it should not be reduced until payments are actually made. Similarly, the amount reported as a reduction of shareholders' equity should be reduced only when the ESOP makes payments on the debt. These two accounts should move symmetrically.

MEASURING COMPENSATION EXPENSE

.09 The Division believes that the amount contributed or committed to be contributed to an ESOP with respect to a given year should be the measure of the amount to be charged to expense by the employer.[3] Such contributions measure the amount of expense irrevocably incurred whether or not they are used concurrently to reduce the debt guaranteed by the employer.

.10 Since the debt of the ESOP is, in substance, the employer's debt, the Division believes that the employer should report separately the compensation element and the interest element of the annual contribution, and should disclose the related interest rate and debt terms in the footnotes to the financial statements. However, a significant minority within the Division believes that the entire annual contribution should be reported as compensation expense.

REPORTING DIVIDENDS PAID AND EARNINGS PER SHARE

.11 The Division believes that all shares held by an ESOP should be treated as outstanding shares in the determination of earnings per share. An ESOP is a legal entity holding shares issued by the employer, whether or not those shares have been allocated to employee accounts.

.12 Dividends paid on shares held by an ESOP should be charged to retained earnings. Such dividends should not be included at any time in compensation expense.

.13 A minority within the Division believes that when trust debt proceeds are transferred to the employer corporation, a transaction of a predominantly financing nature has occurred. The minority believes that shares should be considered outstanding for earnings per share calculations only to the extent that they become constructively unencumbered by repayments of debt principal. To do otherwise, according to this minority view, would result in an inconsistent and initially excessive effect on earnings per share in that the total number of shares purchased by the ESOP would be immediately included in the calculation of earnings per share, even though the related compensation expense would be spread over a period of time on the basis of the employer's contribution to the trust. Consistent with this position, the minority would also charge dividends to retained earnings only to the extent that trust shares are unencumbered. Any remaining balance would be reported as additional compensation expense in the period the dividends were declared.

[3] This conclusion is also applicable to ESOPs that have not borrowed funds from a bank or other lender (or issued notes to existing shareholders) to acquire shares of stock in the employer company.

OTHER MATTERS

Investment Tax Credit

.14 The Division believes that the additional investment tax credit should be accounted for (to the extent that it is available and utilized) as a reduction of income tax expense in the same year in which the contribution to the ESOP is charged to expense, irrespective of the accounting for the normal investment tax credit on property acquisitions.[4] This additional credit arises from the contribution to the ESOP, not solely from the property acquisitions of the employer.[5]

Applicability of APB Opinion No. 11

.15 Excess contributions, as defined, made in any one year may be carried over to future periods for income tax purposes. The Division believes that the financial statements of the employer should reflect the tax effect of timing differences in accordance with APB Opinion No. 11.[6]

ACCOUNTING STANDARDS DIVISION

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Accounting Standards Task Force On Employee Stock Ownership Plans

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Thomas P. Kelley, Director
Accounting Standards

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[4] See footnote 3.
[5] See also Section 101(c) of the Revenue Act of 1971.
[6] See footnote 3.

Section 10,140

Statement of Position 77-1 Financial Accounting and Reporting by Investment Companies

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Section 10,140

Statement of Position 77-1 Financial Accounting and Reporting by Investment Companies

[Proposal to Financial Accounting Standards Board to Amend AICPA Industry Audit Guide on Audits of Investment Companies]

AICPA

American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

April 15, 1977

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying Statement of Position of the Accounting Standards Division proposes changes to the AICPA Industry Audit Guide on Audits of Investment Companies to give effect to developments that have taken place since the Guide was published in 1973. It was prepared on behalf of the Division by the Accounting Standards Task Force on Investment Companies for consideration by the Financial Accounting Standards Board and for such action as the Board deems appropriate.

The Statement includes a section on money-market funds, which were not discussed specifically in the Guide. This section suggests reporting formats suitable for reporting the changes in net assets of money-market funds and provides guidance with respect to the presentation of the per-share data included in the financial statements as "Supplementary Information." In addition, the section contains recommendations on accounting and reporting for gains and losses on short-term investments.

The advent of listed options has increased trading volume significantly, and substantive procedural changes in the mechanics of the options market system have been codified and implemented. Accordingly, the Statement recommends that the sections of the Guide dealing with put and call options should be superseded. The Statement includes an expanded glossary, a discussion of industry practices, and recommendations on appropriate accounting and disclosure.

In recent years, a significant number of no-load funds, particularly money-market funds, have borne their own organization expenses. The Statement concludes, among other things, that expenses incurred by a newly organized open-end investment company in preparing its initial registration statement and obtaining clearance of such registration statement by the SEC should be considered part of its organization expense and accounted for as such. Expenses incurred after that registration statement has been declared effective by the SEC, such as printing a supply of prospectuses to be used for sales purposes, are not organization expenses. The Statement also contains recommendations with respect to the amortization of costs deferred by an investment company.

Finally, the Statement proposes an amendment to the discussion in the Guide of the valuation of short-term investments to make it clear that all investments, including short-term investments (money-market instruments), should be carried at amounts that approximate market or fair value.

Members of the Task Force will be glad to meet with you or your representatives to discuss this proposal. The Task Force would also appreciate being advised as to the Board's proposed action on the recommendations set forth in this Statement of Position.

Sincerely yours,

James H. Muller

James H. Muller
Chairman
Accounting Standards Task Force on
Investment Companies

cc: Securities and Exchange Commission

NOTES

The American Institute of Certified Public Accountants has issued a series of industry-oriented Audit Guides that present recommendations on auditing procedures and auditors' reports and in some instances on accounting principles, and a series of Accounting Guides that present recommendations on accounting principles. Based on experience in the application of these Guides, AICPA Task Forces may from time to time conclude that it is desirable to change a Guide. A Statement of Position is used to revise or clarify certain of the recommendations in the Guide to which it relates. A Statement of Position represents the considered judgment of the responsible AICPA Task Force.

To the extent that a Statement of Position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the Audit Guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the Task Force.

To the extent that a Statement of Position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the Task Force are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the Task Force believes would be in the public interest.

Accounting Standards Task Force
on Investment Companies

JAMES H. MULLER, *Chairman*
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JOHN WOODCOCK, JR.

THOMAS P. KELLEY, *Director*
Accounting Standards

FINANCIAL ACCOUNTING AND REPORTING BY INVESTMENT COMPANIES

Proposed Amendment to Industry Audit Guide

INTRODUCTION

.01 The AICPA Industry Audit Guide, *Audits of Investment Companies,* notes that "changes in the rules, regulations, practices, and procedures of the investment company industry have been frequent and extensive in recent years" and that "further changes are under consideration." A number of changes and new developments have taken place since the Guide was published in 1973 which the Accounting Standards Division believes should be reflected in an amendment to the Guide.

.02 This proposed amendment presents the Division's views on the following matters:

- Money-market funds (an addition to the Guide)
- Put and call options (supersedes discussion in the Guide)
- Expenses during the development stage (an addition to the Guide)
- Amortization of deferred costs (an addition to the Guide)
- Valuation of short-term investments (an amendment to the Guide)

.03 The Guide includes collective trust funds within its general definition of investment companies, but has no discussion of regulatory and tax matters specifically applicable to such funds. Although collective trust funds are not investment companies within the definition of the Investment Company Act of 1940 and are not regulated under the Securities Acts, the accounting and auditing discussions in the Guide are applicable to such funds, where relevant. In addition, the auditor should be familiar with Regulation 9 of the Comptroller of the Currency, which is the regulatory standard for most collective funds operated by banks, and Subchapter H of the Internal Revenue Code, which contains rules for the specialized tax treatment of collective funds.

MONEY-MARKET FUNDS

Background

.04 Money-market funds are open-end management investment companies that invest principally in money-market instruments (short-term government obligations, commercial paper, bankers' acceptances, certificates of deposit, and so forth) with the objective of preserving capital, maintaining liquidity, and obtaining current income. As such, money-market funds are subject to the provisions of the AICPA Industry Audit Guide, *Audits of Investment Companies.*

.05 At the time the Guide was published in October 1973, only a few money-market funds were in operation, and the Guide did not discuss such funds specifically. However, many more have commenced operations since that date, and the Division believes that specific guidance for money-market funds is now desirable.

Distribution Policies

.06 Many money-market funds declare dividends daily, thereby maintaining net asset value per share at or near a fixed amount, depending on which of the following distribution policies is adopted.

Distribution Policy	*Effect on Net Asset Value per Share*
(a) Define income for dividend purposes as the sum of net investment income, net realized gain (loss), and net unrealized appreciation (depreciation). If income, as defined, is a negative amount for any day, that amount is first offset against undistributed dividends accrued during the month in each shareholder's account. If a negative amount remains in a shareholder's account, outstanding shares are reduced by treating each such shareholder as having contributed shares to the fund to the extent of such negative amount.	Net asset value remains fixed.
(b) Define income as in (a) above, but take no action for any day in which such income is a negative amount.	Net asset value remains fixed unless income, as defined, is a negative amount, in which case net asset value will be less than the fixed amount until restored to the fixed amount through subsequent income, as defined.

Distribution Policy	*Effect on Net Asset Value per Share*
(c) Define income for dividend purposes as the sum of net investment income and net realized gain (loss).	Net asset value varies from the fixed amount to the extent of unrealized appreciation or depreciation. Also, it is reduced if income, as defined, is a negative amount that is not offset by unrealized appreciation (net realized loss exceeds net investment income and unrealized appreciation).
(d) Declare daily dividends from net investment income only; distribute net realized gain annually.	Net asset value varies from the fixed amount to the extent of the sum of undistributed realized gain (loss) and unrealized appreciation (depreciation).

.07 Long-term capital gains, as defined in the Internal Revenue Code, may be distributed only once every 12 months unless a specific exemption is obtained.[1] Therefore, a fund that expects to realize long-term gains and that wishes to follow distribution policy (a), (b), or (c) will need to request exemption from Section 19(b) of the 1940 Act to avoid adverse consequences.

.08 See paragraphs .46-.47 of this Statement for a discussion of the valuation of short-term investments.

Statement of Changes in Net Assets

.09 A modification of the format suggested in the Guide for the Statement of Changes in Net Assets is required to report clearly the effects of following one of the distribution policies described in (a), (b), or (c) in the preceding section.

.10 A fund that follows distribution policy (a) or (b) should include a subtotal for net investment income and net realized gain (loss) and unrealized appreciation (depreciation) in the Statement of Changes in Net Assets. This subtotal represents income as defined for dividend purposes.

[1] Section 19(b) and Rule 19b-1 of the Investment Company Act of 1940.

.11 The following format is appropriate for the Statement of Changes in Net Assets (shown in part) of a money-market fund that has adopted distribution policy (a) or (b).

From Investment Activities	19X1	19X0
Net investment income	$100,000	$80,000
Net realized gain (loss) on investments	2,000	(1,000)
Increase (decrease) in unrealized appreciation of investments	(3,000)	1,000
Total available for distribution	$ 99,000	$80,000
Dividends declared	99,500	80,000
Decrease in assets derived from investment activities[2]	$ (500)	—

.12 The following format is suggested for the Statement of Changes in Net Assets (shown in part) of a money-market fund that follows distribution policy (c); that is, it distributes the sum of net investment income and net realized gain or loss daily.

From Investment Activities	19X1	19X0
Net investment income	$100,000	$80,000
Net realized gain (loss) on investments	2,000	(1,000)
Total available for distribution	$102,000	$79,000
Dividends declared	(102,000)	(79,000)
Increase (decrease) in unrealized appreciation of investments	(3,000)	1,000
Increase (decrease) in net assets derived from investment activities	$ (3,000)	$ 1,000

[2] A decrease in net assets derived from investment activities would be reported by a company following distribution policy (b) only if the company incurred a net loss (realized and unrealized) on investments that was not offset by net investment income and net gains (realized and unrealized) prior to the end of the reporting period.

.13 Money-market funds that follow distribution policy (d), or that do not declare dividends daily, should follow the presentation on page 101 of the Guide.

Supplementary Information

.14 The per-share data included in the financial statements as "Supplementary Information" should be presented on a basis consistent with the presentation of the Statement of Changes in Net Assets, as illustrated or discussed above.[3] A fund that follows distribution policy (a) and that has treated each shareholder as having contributed shares to the fund when income, as defined, is a negative amount, should include an additional line item in the per-share data to show the effect of such action.

.15 The investment policies of money-market funds are such that gains and losses, whether realized or unrealized, are usually incidental to the realization of investment income. Also, the dividend policy adopted by a fund should have no effect on the reported ratio of income to average net assets, because the purpose of the ratio is to indicate the effective rate of earnings, regardless of when the earnings are distributed. Accordingly, the most significant ratio for a money-market fund to report is the ratio of net investment income, plus or minus realized and unrealized gains or losses, to average daily net assets. When supplementary information is provided by a money-market fund, this ratio should be reported instead of the ratio of net investment income to average net assets, which is included in the illustration of "Supplementary Information" in the Guide.

.16 It may be appropriate for a fund that distributes only net investment income (distribution policy (d)) to provide a breakdown of the ratio, in a footnote or parenthetically, indicating the portion applicable to realized and unrealized gains or losses, if they are significant.

.17 When yield information is presented as "Supplementary Information" or elsewhere in the financial statements, a description of the method of computation should be provided.

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[3] Income (as defined) per share should be based on the per-share dividends declared during the period and prorated by components based on the amounts shown in the Statement of Operations. For example, a fund following distribution policy (a) or (b) would apportion its per-share income (as defined) between net investment income and realized and unrealized gain (loss).

Reporting Gains and Losses

.18 When short-term investments, including discounted instruments, are sold prior to maturity, realized gains and losses should be recorded as such, based on the difference between the proceeds from sale and cost (amortized cost in the case of discounted instruments). However, net realized gains or losses are ordinarily not significant in relation to the total dollar amount of sales of money-market instruments. Further, such gains or losses are rarely significant in relation to the results of operations of a money-market fund. Accordingly, except in unusual circumstances, a money-market fund need not report the proceeds from sales and the cost of securities sold in the Statement of Operations; it need report therein only the amount of net realized gain or loss.

.19 Changes in unrealized appreciation or depreciation should be reported following the presentation on page 100 of the Guide.

Federal Income Taxes

.20 A fund that includes unrealized appreciation or depreciation in dividends may have distributed more or less than its taxable income in a particular year. Accordingly, a fund that follows such a policy should pay particular attention to the provisions of the Internal Revenue Code relating to the distribution of taxable income, as discussed more fully in chapter 5 of the Guide.

PUT AND CALL OPTIONS

Background

.21 An active public market has been developed in listed call options, and trading in listed put options is expected in early 1977. Although there has been an over-the-counter market in options for many years and the public has participated to some degree, the advent of listed options has increased trading volume significantly, and substantive procedural changes in the mechanics of the options market system have been codified and implemented. Accordingly, the Division believes that the sections of *Audits of Investment Companies* covering options should be amended to give appropriate guidance with respect to an investment company that purchases or sells options. This Statement of Position supersedes the following sections of the Guide:

- Valuation of Put and Call Options Purchased (chapter 3, "Investment Accounts," page 37)
- Valuation of Put and Call Option Contracts Written by the Investment Company (chapter 3, "Investment Accounts," page 38)
- Put and Call Options (chapter 5, "Taxes," page 69)

Option Trading

.22 The following glossary of terms should be helpful in understanding the mechanics of option trading.

Exchange-Traded Option. A put or call option traded on an exchange and settled through the facilities of an exchange. It gives the buyer of the option ("holder") the right to sell to (put) or buy from (call) the seller ("writer") the number of shares or other units of the underlying security covered by the option at the stated exercise price prior to the fixed expiration date of the option. The designation of an option includes the underlying security, the expiration month, and the exercise price; for example, "XYZ July 50" means that a unit of trading (typically 100 shares) of XYZ stock may be sold or purchased at $50 per share until the option expires on the expiration date in July. Options of like designation are said to be of the same "series."

Underlying Security. The security subject to sale or purchase upon the exercise of the option.

Unit of Trading. The number of units of the underlying security designated as the subject of a single option. In the absence of any other designation, the unit of trading for a common stock is 100 shares.

Exercise Price. The price per share or other unit at which the holder of an option may sell or purchase the underlying security upon exercise. The exercise price is sometimes called the "striking price."

Expiration Date. The last day on which an option may be exercised.

Premium. The aggregate price of an option agreed upon between the buyer and writer or their agents.

Opening Purchase Transaction. A transaction in which an investor becomes the holder of an exchange-traded option.

Opening Sale Transaction. A transaction in which one becomes the writer of an exchange-traded option.

Closing Purchase Transaction. A transaction in which a writer of an exchange-traded option liquidates his position as a writer by "purchasing," in a transaction designated as a closing purchase transaction, an option having the same terms as the option previously written. Such a transaction has the effect, upon payment of the premium, of canceling the writer's pre-existing position instead of resulting in the issuance of an option.

Closing Sale Transaction. A transaction by which a holder of an option liquidates his position as a holder by "selling," in a transaction designated as a closing sale transaction, an option having the same terms as the option previously purchased. Such a transaction has the effect of liquidating the holder's pre-existing position instead of resulting in the holder's assuming the obligation of a writer.

Covered Writer. A writer of a call option who, as long as he remains a writer, owns the shares or other units of the underlying security covered by the option. The writer of a put is "covered" only when he purchases an option on the same underlying security with an exercise price equal to or greater than that of the option written.

Uncovered Writer. A writer of an option who is not a covered writer; sometimes referred to as "naked."

Option Writing

.23 As consideration for the rights and obligations represented by an option, the buyer pays, and the writer receives, a premium. The premium is determined in the exchanges' option markets on the basis of supply and demand, reflecting factors such as the duration of the option, the difference between the exercise price and the market price of the underlying security, and the price volatility and other characteristics of the underlying security. A covered writer of a call option gives up, in return for the premium, the opportunity for profit from an increase in the price of the underlying security above the exercise price as long as the option obligation continues, but he retains the risk of loss should the price of the security decline. Since the option holder may exercise the option and purchase the securities at the designated price at any time prior to the expiration date of the option, the option writer has no control over the date of sale.

.24 An uncovered writer of a call option assumes, in return for the premium, the obligation to provide the option holder with the underlying securities upon exercise of the option. The uncovered writer, therefore, may have a substantial risk of loss should the price of the security increase, but he has no risk of loss should the price of the security decrease.

.25 As long as a secondary market in options remains available on each of the exchanges, the writer of an option traded on an exchange is able to liquidate his position prior to the exercise of such option by entering into a closing purchase transaction. Such a transaction has the effect of canceling the writer's pre-existing position. The cost of such a liquidating purchase, however, can be greater than the premium received upon writing the original option.

.26 Because the purchaser or writer has the ability to enter into a closing transaction, the option originally written may never be exercised. The exercise of an exchange-traded option takes place only through the Options Clearing Corporation (OCC), which is the obligor on every option, by the timely submission of an exercise notice by the clearing broker acting on behalf of the exercising holder. The exercise notice is then "assigned" by the OCC to a clearing broker acting on behalf of a writer of an option of the same series as the exercised option. This broker is then obligated to deliver the underlying security against payment of the aggregate exercise price. The assigned broker is randomly selected from clearing members having accounts with the OCC with options outstanding of the same series as the option being exercised.

.27 Most investment companies deposit securities underlying the options written in order to guarantee delivery in the event the option is exercised.

Accounting

.28 Portfolio securities underlying call options should be reported at value, determined in accordance with the provisions of the Guide, and reflected in net asset value accordingly. Premiums received by an investment company from the sale of outstanding call options should be included in the liability section of the Statement of Assets and Liabilities as a deferred credit and subsequently adjusted to the current market value (marked-to-market) of the option written. For example, if the current market value of the option exceeded the premium received (which should be shown parenthetically in the Statement of Assets and Liabilities), the excess would be an unrealized loss and, conversely, if the premium exceeded the current market value, such excess would be an unrealized gain. Current market value of exchange-traded options should be the last sales price or, in the absence of a transaction, the mean between the closing bid and ask prices, or the ask prices, in accordance with the valuation policy followed by the fund. The change in unrealized depreciation or appreciation resulting from the mark-to-market may be included with unrealized gains or losses on the portfolio in the Statement of Operations and Statement of Changes in Net Assets, with disclosure as to the amount, or it may be reported as a separate line item.

.29 With respect to covered options, disclosure, summarized by security, should be made of the description and number of shares of portfolio securities covering outstanding options and the market value of the options. Disclosure should also be made of the aggregate market value of the securities or other assets deposited as collateral. With respect to uncovered options, disclosure should be made of the description and quantity of securities under option, the expiration dates and exercise prices, the current market prices of the securities covered by the options, and the assets deposited in escrow with respect to such options.

.30 Subsequent to the sale of a call option, any one of three events may occur: the option may expire on its stipulated expiration date; the writer may enter into a closing transaction; or the option holder may exercise his right to call the security. Either of the first two events results in a realized gain (or loss if the cost of the closing transaction exceeds the premium received when the option was sold) for the investment company option writer and should be accounted for as such. The third possible event results, in the case of a covered writer, in the sale of the underlying securities, unless the writer purchases like securities for delivery to the exercising holder. The proceeds should be increased by the amount of premium originally received, and realized gains or losses resulting from such sales should be accounted for in the conventional manner. If an uncovered option is exercised, the writer must purchase the underlying securities in order to meet his obligation to the option holder. In such situations, the writer's realized loss resulting from the simultaneous purchase and sale of the securities should be reduced by the premium originally received, and the net realized loss (or gain) should be accounted for in the conventional manner.

.31 The foregoing describes the accounting for the sale of call options. The same principles are applicable to the sale of put options.

.32 Actively traded put and call options purchased by an investment company should be accounted for in the same manner as marketable portfolio securities. The cost of portfolio securities acquired through the exercise of call options should be increased by the premium paid to purchase the call. The proceeds from securities sold through the exercise of put options should be decreased by the premium paid to purchase the put.

.33 Transactions in options not listed on a national exchange or not actively traded should be accounted for as described in the foregoing paragraphs, except that the determination of unrealized gain or loss during the contract period of the option must be based on the fair value of the option as determined by the investment company's board of directors. Among the many factors to be considered in the determination of fair value are the price of the underlying securities, the liquidity of the market, and the time remaining prior to expiration date.

Federal Income Taxes

.34 The following paragraphs are intended to supersede only that portion of chapter 5 of the Guide ("Taxes") dealing with put and call options. Reference to that chapter should be made for other information pertinent to the taxation of investment companies.

.35 For federal income tax purposes, premium income from the sale of options is deferred until expiration or exercise of the option, or until a closing purchase transaction takes place. If the option expires, the premium constitutes a short-term capital gain. If the option is exercised and the underlying securities are sold, the premium is added to the proceeds from the sale of the securities in determining capital gain or loss. Such gain or loss is short-term or long-term depending upon the holding period of the underlying securities. If the option is closed in a closing purchase transaction, the difference between the amount paid for the option purchased and the premium received on the original sale is a short-term capital gain or loss.[4]

.36 Under the Internal Revenue Code, an investment company cannot qualify as a regulated investment company unless, among other things, less than 30 percent of its gross income is derived from gains from the sale or other disposition of securities held for less than three months ("30 percent rule"). Therefore, in order to be taxable as a regulated investment company, its ability to write options with exercise periods of less than three months or to effect closing purchase transactions within three months of writing options is restricted. For purposes of meeting this "three-month test," the holding period for the sale of an option commences on the day it is written.

.37 An investment company must derive at least 90 percent of its gross income from dividends, interest, and gain from the sale or other disposition of stock or securities ("investment income"), in order to qualify as a regulated investment company in any taxable year. For tax purposes, income received from expired call options and from profits in executing closing purchase transactions for amounts less than the call premiums received qualifies as investment income.

EXPENSES DURING THE DEVELOPMENT STAGE

.38 The standards of financial accounting and reporting set forth in FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises*, are applicable to financial statements issued by investment companies that are in the development stage, as defined in the FASB Statement. The following paragraphs in this section discuss certain expenses that may be incurred by an investment company that is in the development stage.

.39 A newly formed investment company will incur organization expenses unless it is sponsored by a management company that has agreed to absorb these expenses. Organization expenses consist of expenses incurred in order to establish the company and legally equip it to engage in business. In recent years, a

[4] The termination of a writing position that was established on or before September 1, 1976, by lapse of the option or by a closing purchase transaction, will produce ordinary income or loss.

significant number of no-load funds, particularly money-market funds, have borne their own organization expenses.

.40 An open-end investment company, which is organized to offer shares of capital stock to the public continuously and to invest the proceeds from sale of such capital stock, cannot be considered to be organized until it has registered securities with the Securities and Exchange Commission. Therefore, expenses incurred by a newly organized open-end investment company in preparing its initial registration statement and obtaining clearance of such registration statement by the SEC should be considered part of its organization expenses; expenses incurred after that registration statement has been declared effective by the SEC, such as printing a supply of prospectuses to be used for sales purposes, are not organization expenses.

.41 As stated in *Audits of Investment Companies,* "closed-end companies charge all registration fees against paid-in capital at the time the shares are sold." This Statement of Position does not modify that requirement.

.42 Once an investment company has been organized to do business, it usually engages immediately in its planned principal operations, that is, sales of capital stock and investment of funds. The training of employees, development of markets for the sale of capital stock, and similar activities are usually performed by the investment adviser or other agent, and in such cases the costs of these activities are not borne directly by the investment company. However, an investment company (particularly one that does not employ agents to manage its portfolio and perform other essential functions) may engage for a period of time in such activities, and may bear those costs directly during its development stage.

.43 As stated above, an investment company that is in the development stage is subject to the provisions of FASB Statement No. 7. Paragraph 10 of the FASB Statement notes that "generally accepted accounting principles that apply to established operating enterprises . . . shall determine whether a cost incurred by a development stage enterprise is to be charged to expense when incurred or is to be capitalized or deferred." Accordingly, the costs and expenses discussed in the preceding paragraphs should be accounted for in accordance with the generally accepted accounting principles that apply to established operating enterprises. Organization expenses of investment companies are usually deferred and amortized in financial statements prepared in conformity with generally accepted accounting principles.

AMORTIZATION OF DEFERRED COSTS

.44 Costs deferred by an investment company should be subject to the same assessment of recoverability that would be applicable to any established operating company. Such costs should be amortized to income over the period during which it is expected that a benefit will be realized. That period may vary according to the type of expense. Several costs are listed below.

Organization Expenses. Generally such expenses are amortized over a period of not more than 60 months from the date of commencement of operations. Straight-line or other acceptable methods of amortization may be utilized.

If such expenses are amortized on the basis of assets expected to be managed over the period selected, the projected growth rate initially used as the basis for establishing an amortization table should be reviewed frequently and adjusted, if necessary, to reflect actual experience.

Cost of Printing Prospectuses. Costs deferred in connection with printing a supply of prospectuses for sales purposes should be amortized, generally on a straight-line basis, over the period during which the prospectus may be used, which is limited to a period ending 16 months after the date of the latest audited financial statements. If during this period it becomes evident that the prospectus will be effective for a shorter period than originally anticipated, amortization should be accelerated so that no costs remain deferred at the end of such shorter period.

Registration Fees. Deferred SEC and state registration fees should be written off as the registered shares of stock are sold (but over not more than 60 months).

.45 The summary in the financial statements describing an investment company's significant accounting policies should cover the company's accounting for deferred costs.

VALUATION OF SHORT-TERM INVESTMENTS

.46 The discussion of the valuation of short-term investments on page 39 of the Guide states that "original cost plus amortized discount or accrued interest . . . usually approximates market value.'' This statement was made when holdings of short-term investments generally constituted a small portion of an investment company's portfolio. It was not intended to modify the principle that "all investment companies should report their securities portfolio at value.'' In all cases, the board of directors should be satisfied that investments, including short-term investments (money-market instruments), are carried at amounts that approximate market or fair value. Accordingly, the Division believes that the discussion entitled Short-Term Investments on page 39 of the Guide should be amended by the addition of the following paragraph:

> Although the amortized cost of money-market instruments that mature within a relatively short period of time ordinarily approximates market value, it must be recognized that unusual events, such as the impairment of the credit standing of the issuer, can significantly affect the value of short-term investments regardless of the number of days to maturity. Changes in interest rates can also have a significant effect on the value of money-market instruments with longer terms to maturity. In such cases, amortized cost might not approximate the value of these investments. When amortized cost does not approximate value, the investments should be valued on the basis of quoted sales prices, bid and asked prices, or fair value based upon appraisals furnished by market makers or other appropriate evidence.

Section 10,150

Statement of Position 77-2 Accounting for Interfund Transfers of State and Local Governmental Units

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Section 10,150

Statement of Position 77-2 Accounting for Interfund Transfers of State and Local Governmental Units

[Proposal to Financial Accounting Standards Board to Amend AICPA Industry Audit Guide on Audits of State and Local Governmental Units]

AICPA

American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

September 1, 1977

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying statement of position, prepared by the AICPA State and Local Government Accounting Committee, proposes amendments to the AICPA Industry Audit Guide on Audits of State and Local Governmental Units. The statement of position will amend part of chapter 2 of the guide which deals with interfund transfers of state and local governmental units.

Members of the committee will be glad to meet with you or your representatives to discuss this proposal. The committee would also appreciate being advised as to the board's proposed action on its recommendations.

Sincerely yours,

Frank S. Belluomini

Frank S. Belluomini, Chairman
State and Local Government
Accounting Committee

cc: Securities and Exchange Commission

NOTES

The American Institute of Certified Public Accountants has issued a series of industry-oriented audit guides that present recommendations on auditing procedures and auditors' reports and in some instances on accounting principles, and a series of accounting guides that present recommendations on accounting principles. Based on experience in the application of these guides, AICPA task forces, subcommittees, or committees may from time to time conclude that it is desirable to change a guide. A statement of position is used to revise or clarify certain of the recommendations in the guide to which it relates. A statement of position represents the considered judgment of the responsible AICPA task force, subcommittee, or committee.

To the extent that a statement of position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the audit guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the committee.

To the extent that a statement of position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the committee are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the subcommittee believes would be in the public interest.

ACCOUNTING FOR INTERFUND TRANSFERS OF STATE AND LOCAL GOVERNMENTAL UNITS

Proposed Amendment to Industry Audit Guide

BACKGROUND INFORMATION

.01 Chapter 2 of the AICPA Industry Audit Guide, *Audits of State and Local Governmental Units,* includes accounting guidelines for four categories of interfund transfers. The first category comprises transactions that would be treated as revenues or expenditures had they been conducted with outsiders. These transfers are accounted for as revenues of the recipient fund and expenditures of the disbursing fund. The second category comprises reimbursements of expenditures made by one fund for another. The reimbursement reduces the expenditures of the recipient fund. The third category comprises recurring annual transfers between two or more budgetary funds for shifting resources from a fund legally required to receive revenue to a fund authorized to expend the revenue. These transfers are shown as separate items in each fund's statement of revenues and expenditures or equivalent financial statement. The fourth category comprises nonrecurring transfers between funds that are analogous to capital transactions and that represent a transfer of equity of the funds involved. These transfers are treated as direct additions to or deductions from the fund balances.

.02 After publication of the guide, questions arose concerning which category covers those transfers between a general or special revenue fund and an enterprise fund that subsidize the operations of the recipient fund. Such transfers are similar to those covered by the third category. The guide limits the third category to budgetary funds, and to recurring transfers; however, the transfers in question involve enterprise funds and may or may not recur.

.03 The Committee on State and Local Government Accounting believes that the third category should include transfers between funds other than budgetary funds, particularly transfers between a general or special revenue fund and an enterprise fund. The committee also believes that the category should not be restricted to recurring annual transfers.

RECOMMENDATION

.04 The committee believes that *Audits of State and Local Governmental Units* should be amended by replacing paragraph 3, page 11, with the following paragraph:

3. The third category incudes all transfers except those covered in categories 1 and 2, above, and those representing nonrecurring transfers of equity (category 4, below). Typically these represent legally authorized transfers from a fund receiving revenue to a fund that will use the amount transferred. Some examples are as follows:

   a. Annual transfers from a state's general fund to the state's school aid fund.

   b. Budgeted transfers from the general fund to a capital projects fund. Expenditure from the capital projects fund of the transferred monies may occur in the year of transfer or in subsequent years.

   c. Transfers from the general fund or a special revenue fund to an enterprise fund that serves as a subsidy for the operations of the enterprise.

d. Transfers from an enterprise fund, other than payments in lieu of taxes, to the general fund that serve as a resource for general fund expenditures.

The transfers received and made should appear as separate items in each fund's statement of revenue, expenditures, and transfers or equivalent financial statement. (See "Illustrative Forms of Certain Financial Statements and Supplemental Schedules of Governmental Units," example 5, p. 103.) For enterprise funds, such transfers should appear on the income statement after net operating income or loss.

ACCOUNTING STANDARDS DIVISION

State and Local Government Accounting Committee

Frank S. Belluomini,
Chairman

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Paul Rosenfield, *Director Accounting Standards*
Gabriel V. Carifi, *Manager Accounting Standards*

Section 10,160

Statement of Position 78-1 Accounting by Hospitals for Certain Marketable Equity Securities

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Section 10,160

Statement of Position 78-1 Accounting by Hospitals for Certain Marketable Equity Securities

[Proposal to Financial Accounting Standards Board to Amend AICPA Industry Audit Guide on Audits of Hospitals]

AICPA American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

May 1, 1978

Donald J. Kirk, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Kirk:

The accompanying statement of position, prepared by the AICPA Subcommittee on Health Care Matters, proposes amendments to the AICPA Industry Audit Guide on Audits of Hospitals. The statement of position will amend part of chapter 2 of the guide which deals with investment income and gains (losses).

Members of the subcommittee will be glad to meet with you or your representatives to discuss this proposal. The subcommittee would also appreciate being advised as to the board's proposed action on its recommendations.

Sincerely yours,

Albert A. Cardone

Albert A. Cardone, Chairman
Subcommittee on Health
Care Matters

NOTES

The American Institute of Certified Public Accountants has issued a series of industry-oriented audit guides that present recommendations on auditing procedures and auditors' reports and, in some instances, on accounting principles, and a series of accounting guides that present recommendations on accounting principles. Based on experience in the application of these guides, AICPA subcommittees or task forces may from time to time conclude that it is desirable to change a guide. A Statement of Position is used to revise or clarify certain of the recommendations in the guide to which it relates. A Statement of Position represents the considered judgment of the responsible AICPA subcommittee or task force.

To the extent that a Statement of Position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the audit guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the subcommittee or task force.

To the extent that a Statement of Position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the subcommittee or task force are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the subcommittee or task force believes would be in the public interest.

ACCOUNTING BY HOSPITALS FOR CERTAIN MARKETABLE EQUITY SECURITIES

.01 Statement of Financial Accounting Standards No. 12, *Accounting for Certain Marketable Securities*, issued by the Financial Accounting Standards Board, states in the first sentence of paragraph 5 that it "does not apply to not-for-profit organizations," which are those described in the Introduction to Accounting Research Bulletin No. 43. Thus, FASB Statement No. 12 applies to investor-owned hospitals and does not apply to not-for-profit hospitals.

.02 The AICPA Subcommittee on Health Care Matters believes that the *Hospital Audit Guide* should be amended by deletion of the section "Investment Income and Gains (Losses)" and inclusion of the following new section.

ACCOUNTING FOR CERTAIN MARKETABLE EQUITY SECURITIES

.03 Investor-owned hospitals are subject to the requirements of FASB Statement No. 12 and interpretations of that Statement, which specify the accounting and disclosure requirements applicable to portfolios of marketable equity securities. Under

Statement No. 12, cost is no longer an acceptable accounting method for marketable equity securities, and the carrying amount of a marketable equity security portfolio that was previously carried at cost should now be the lower of its aggregate cost and market values.[1]

.04 Similarly, cost should no longer be used by not-for-profit hospitals for marketable equity securities. The carrying amount of a marketable equity security portfolio of a not-for-profit hospital that was previously carried at cost should now be the lower of its aggregate cost and market value, determined at the balance sheet date. The amounts by which the aggregate cost of each portfolio exceeds market value should be accounted for as valuation allowances.

.05 Marketable equity securities owned by a not-for-profit hospital should be grouped into separate portfolios, as indicated below, for the purpose of comparing aggregate cost and market value to determine carrying amount.

1. Marketable equity securities included in unrestricted funds should be grouped into separate portfolios according to the current or noncurrent classification of the securities.
2. Marketable equity securities included in different types of restricted funds should be grouped into separate portfolios according to types of funds (for example, portfolios of marketable equity securities included in various specific purpose funds should be grouped together but not with those in endownment funds).
3. The current portfolios of unrestricted funds of entities that are combined in financial statements should be treated as a single combined portfolio; the noncurrent unrestricted portfolios of those entities should also be treated as a single combined portfolio: similar restricted fund portfolios of entities that are combined in financial statements should be treated as single portfolios (for example, portfolios of marketable equity securities included in the various specific purpose funds of a not-for-profit hospital should be combined with the portfolios of marketable equity securities held in the various specific purpose funds of an entity whose financial statements are combined with those of the not-for-profit hospital).

[1] Reference should be made to paragraph 7 of FASB Statement No. 12 for definitions of the following terms: equity security, marketable, market price, market value, cost, valuation allowance, carrying amount, realized gain or loss, net unrealized gain or loss.

.06 If there is a change in a marketable equity security's classification between current and noncurrent assets in unrestricted funds, the security should be transferred between the corresponding portfolios at the lower of its cost and market values at the date of transfer. If market value is less than cost, the market value becomes the new cost basis, and the difference is accounted for as if it were a realized loss and is included in the nonoperating revenues section of the statement of revenues and expenses.

.07 Changes in the valuation allowance for a marketable equity securities portfolio included in current assets in unrestricted funds should be disclosed in the nonoperating revenues section of the statement of revenues and expenses. Changes in the valuation allowance for a marketable equity securities portfolio included in noncurrent assets in unrestricted funds or assets in restricted funds should be disclosed in the respective statements of charges in fund balances; accumulated changes in the valuation allowance for such portfolios should be disclosed in the appropriate fund balance in the balance sheet.

.08 If the hospital pools its investments (which could include investments of current and noncurrent unrestricted funds and investments of restricted funds), the cost of marketable equity securities in the fund(s) should be compared to the allocation of the market value of the pooled marketable equity securities for purposes of implementing the above recommendations. To apply those provisions properly, marketable equity securities and other investments must be accounted for separately.

.09 Income from investments of board-designated and other unrestricted funds and realized gains or losses on sales of investments of board-designated and other unrestricted funds should be included in the statement of revenues and expenses as nonoperating revenue of the period in which they are earned or incurred.

.10 Realized gains or losses on the sale of investments of endowment funds should be added to or deducted from endowment fund principal unless such amounts 'are legally available for other use or chargeable against other funds. Investment income of those funds should be accounted for in accordance with the donors' instructions—for example, as resources for specific operating purposes if restricted, or nonoperating revenue if not.

.11 Income and net realized gains or losses on investments of restricted funds other than endowment funds should be charged or credited to the respective fund balance unless such amounts are legally available for or chargeable against other funds. If such amounts are legally available for unrestricted purposes, they should be included in nonoperating revenue. Gains or losses on investment trading between unrestricted and restricted funds and between various categories of restricted funds (for example, between endowment and plant replacement funds) should be recognized as realized gains or losses and separately disclosed in the financial statements. Gains or losses resulting from transactions between various board-designated funds of the unrestricted fund should not be recognized.

.12 The following information with respect to owned marketable equity securities should also be disclosed either in the body of the financial statements or in the accompanying notes:

1. As of the date of each balance sheet presented, aggregate cost and market values for each separate portfolio into which marketable equity securities were grouped to determine carrying amount, with identification of which is the carrying amount.
2. As of the date of the latest balance sheet presented, the following segregated by portfolio—
   a. Gross unrealized gains representing the excess of market value over cost for all marketable equity securities having such an excess in the portfolio.
   b. Gross unrealized losses representing the excess of cost over market value for all marketable equity securities having such an excess in the portfolio.
3. For each period for which a statement of revenues and expenses is presented—
   a. Net realized gain or loss included in nonoperating revenue.
   b. The basis on which cost was determined in computing realized gain or loss (average cost or other method).

.13 The financial statements should not be adjusted for realized gains, losses, or changes in market prices with respect to marketable equity securities if such gains, losses, or changes occur after the date of the financial statements but before their issuance, except for the situation covered in the following paragraph. However, significant net realized and net unrealized gains and losses arising after the date of the financial statements but before their issuance applicable to marketable equity securities owned at the date of the most recent balance sheet should be disclosed.

.14 For those marketable securities for which the effect of a change in carrying amount is included in the statement of changes in fund balances rather than in the statement of revenues and expenses, a determination should be made as to whether a decline in market value below cost as of the balance sheet date of an individual security is other than temporary. If the decline is judged to be other than temporary, the cost basis of the individual security should be written down to a new cost basis and the amount of the write-down should be accounted for as a realized loss. The new cost basis should not be changed for subsequent recoveries in market value.

.15 Unrealized gains or losses should not result in adjustment of financial statements, except for changes in the valuation allowance related to marketable equity securities and for declines in value that result from other than temporary impairment.

.16 The disclosures in Note 1 to the sample financial statements on page 48 of the *Hospital Audit Guide* should conform with the disclosures set forth in this amendment.

TRANSITION

.17 The subcommittee recommends that this amendment be applied to financial statements for fiscal years beginning on or after the first day of the first month following the date of this Statement and encourages earlier application. If the initial application of this Statement requires the establishment of a valuation allowance, financial statements previously issued should not be restated. If the establishment of a valuation allowance is required for a marketable equity securities portfolio included in current assets in unrestricted funds, the effect of the change should be included in the determination of the excess of revenue over expense for the period of the change in accordance with the provisions of APB Opinion 20. If the establishment of a valuation allowance is required for a marketable equity securities portfolio included in noncurrent assets in unrestricted funds or assets in restricted funds, the effect of the change should be presented in the statement of changes in fund balances.

SUBCOMMITTEE ON HEALTH CARE MATTERS

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The subcommittee gratefully acknowledges the contributions made to the development of this Statement of Position by former members of the subcommittee, Robert A. Cerrone, William Freitag, and Robert F. Rosenstiel.

Section 10,170

Statement of Position 78-2 Accounting Practices of Real Estate Investment Trusts

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Section 10,170

Statement of Position 78-2 Accounting Practices of Real Estate Investment Trusts

[Proposal to Financial Accounting Standards Board to Amend Statement of Position 75-2]

AICPA American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

May 12, 1978

Donald J. Kirk
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Kirk:

The accompanying statement of position, Accounting Practices of Real Estate Investment Trusts, an Amendment of Statement of Position 75-2, was prepared on behalf of the division by the AICPA's Committee on Real Estate Accounting for consideration of the Financial Accounting Standards Board and for such action as the board deems appropriate. It amends Statement of Position 75-2 to conform the recommendations of that statement to the provisions of Statement of Financial Accounting Standards 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings.

Representatives of the division are available to discuss this proposal with you or your representatives at your convenience. The division would appreciate being advised on the board's proposed action on the recommendations set forth in this statement of position.

Sincerely,

Arthur R. Wyatt, Chairman
Accounting Standards Division

cc: Securities and Exchange Commission

NOTES

Statements of Position of the AICPA Accounting Standards Division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of Statements of Position is to influence the development of accounting and reporting standards in directions the Division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, Statements of Position do not establish standards enforceable under the Institute's Code of Professional Ethics.

ACCOUNTING PRACTICES OF REAL ESTATE INVESTMENT TRUSTS

INTRODUCTION

.01 The recommended accounting for real estate loans and foreclosed properties in Statement of Position (SOP) 75-2 [section 10,060], *Accounting Practices of Real Estate Investment Trusts,* issued June 27, 1975, is inconsistent with certain provisions of Statement of Financial Accounting Standards 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings,* issued by the Financial Accounting Standards Board in June 1977.

.02 In the section of SOP 75-2 [section 10,060] entitled "Losses from Loans," the Accounting Standards Division recommended that real estate investment trusts (REITs) periodically evaluate individual real estate loans and foreclosed properties held for sale and provide allowances for losses to adjust the carrying amounts of the individual assets at each evaluation date to their estimated net realizable value (as defined in the SOP) or, in the case of foreclosed properties, to their estimated selling price on an immediate liquidation basis if the REIT is unable or unwilling to hold the properties because of liquidity problems or other reasons. The Division recommended that the net realizable value at the date of foreclosure should become the cost basis of a foreclosed property that an REIT elects to hold as a long-term investment.

.03 FASB Statement 15 prescribes the accounting by debtors and creditors, including REITs, for troubled debt restructurings consummated after December 31, 1977. Paragraph 2 of that Statement contains the following definition of a troubled debt restructuring:

> A restructuring of a debt constitutes a *troubled debt restructuring* for purposes of this Statement if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. That concession either stems from an agreement between the creditor and the debtor or is imposed by law or a court. For example, a creditor may restructure the terms of a debt to alleviate the burden of the debtor's near-term cash requirements and many troubled debt restructurings involve modifying terms to reduce or defer cash payments required of the debtor in the near future to help the debtor attempt to improve its financial condition and eventually be able to pay the creditor. Or, for example, the creditor may accept cash, other assets, or an equity interest in the debtor in satisfaction of the debt though the value received is less than the amount of the debt because the creditor concludes that step will maximize recovery of its investment.

A note to that paragraph states:

> Although troubled debt that is fully satisfied by foreclosure, repossession, or other transfer of assets or by grant of equity securities by the debtor is, in a technical sense, not restructured, that kind of event is included in the term *troubled debt restructuring* in this Statement.

Among other things, the Statement requires assets received or transferred in a troubled debt restructuring to be valued at their fair value (as defined in the statement) when the restructuring occurs. (See paragraphs 13, 14, 19, 20, 28, 29, 33, 34, 35, and 42 of that Statement.) The fair value of a property as measured under FASB Statement 15 may differ materially from its net realizable value as measured under the recommendations on losses from loans in Statement of Position 75-2 [section 10,060].

.04 The Accounting Standards Division believes that SOP 75-2 [section 10,060] should be amended, as set forth below, to conform its recommendations to the provisions of FASB Statement 15.

THE DIVISION'S CONCLUSIONS

.05 The following footnote referenced to "foreclosed properties" in the first sentence of the sixth paragraph under the caption "Losses from Loans" is added to SOP 75-2 [section 10,060].

> Statement of Financial Accounting Standards No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings,* prescribes the accounting required for assets received or transferred in troubled debt restructurings consummated after December 31, 1977, with earlier application encouraged. The recommendations in this section, "Losses from Loans," concerning loans and properties have been amended in certain respects to conform with FASB Statement No. 15. (See "Assets Affected by Troubled Debt Restructurings.") The recommendations in this section continue to apply to foreclosed properties acquired before the effective date of FASB Statement No. 15 and for which earlier application of that Statement is not elected.

.06 The following section, "Assets Affected by Troubled Debt Restructurings," is added to SOP 75-2 [section 10,060] to follow immediately after the section "Losses from Loans."

Assets Affected by Troubled Debt Restructurings

Properties acquired by an REIT in a troubled debt restructuring and accounted for in accordance with FASB Statement 15 should be recorded as if they had been acquired for cash at their fair value, which becomes their cost basis for accounting purposes. Periodically thereafter the properties should be evaluated and allowances for losses should be provided in accordance with the recommendations on "Losses from Loans."

When it is probable that an REIT will enter into a troubled debt restructuring with one of its *debtors* that will result in a loss determined in accordance with the provisions of FASB Statement 15 in excess of the allowance, if any, provided in accordance with the recommendation on "Losses from Loans" in this Statement, a provision should be made for the excess loss. Thereafter, until the restructuring occurs, the loan receivable should be periodically evaluated in a similar manner, and the allowance for losses should be adjusted at each evaluation date for changes in the estimated loss. In no event should the loan, less the allowance for loss, exceed its estimated net realizable value.

When it is probable that an REIT will enter into a troubled debt restructuring with one of its *creditors* that will result in a loss on transfer of an identified asset (determined in accordance with FASB Statement 15) in excess of the allowance, if any, provided in accordance with the recommendations on "Losses from Loans" in this Statement, a provision should be made for the excess loss on the identified asset to be transferred net of the related gain, if reasonably determinable, on reduction of the payable that will result from the asset transfer. The Accounting Standards Division believes that it is appropriate to include the effect of the gain in providing for the additional loss, because it is the asset transfer that produces both the loss on transfer and the gain on restructuring. The provision for the excess net loss should be reported as an expense in determining income before extraordinary items. After providing for the excess net loss, the allowance for losses will be an amount that reduces the carrying amount of the identified asset to be transferred to its estimated fair value, net of the related estimated gain (not in excess of the loss on the identified asset to be transferred) on the reduction of the payable that will result from the asset transfer. In no event, however, should the identified asset to be transferred, less the allowance for losses, exceed its estimated net realizable value. The notes to the REIT's financial statements should disclose the effect on the allowance for losses of the estimated gain on the payable to be restructured as described in the preceding sentence. Also, the note should state that, when realized, such gain will be reported as an extraordinary item with a corresponding charge to income before the extraordinary item.

ACCOUNTING STANDARDS DIVISION

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Section 10,180

Statement of Position 78-3 Accounting for Costs to Sell and Rent, and Initial Rental Operations of, Real Estate Projects

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Section 10,180

Statement of Position 78-3 Accounting for Costs to Sell and Rent, and Initial Rental Operations of, Real Estate Projects

[A Proposed Recommendation to the Financial Accounting Standards Board]

AICPA

American Institute of Certified Public Accountants

1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

June 30, 1978

Donald J. Kirk, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Kirk:

The accompanying draft of the statement of position, Accounting for Costs to Sell and Rent, and Initial Rental Operations of, Real Estate Projects, has been prepared on behalf of the accounting standards division by the AICPA committee on real estate accounting and approved by the accounting standards executive committee.

The statement presents the division's recommendations on accounting for costs to sell and costs to rent real estate projects during their selling or renting phases. It also presents the division's recommendations on accounting for costs and revenues during the initial operating period of a rental project—the period before occupancy stabilizes (sometimes referred to as the "rent-up" period).

Representatives of the division are available to discuss this proposal with you or your representatives at your convenience.

Sincerely,

Arthur R. Wyatt

Arthur R. Wyatt, Chairman
Accounting Standards Division

cc: Securities and Exchange Commission

NOTES

Statements of position of the AICPA accounting standards division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the accounting standards executive committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, statements of position do not establish standards enforceable under the Institute's code of professional ethics.

ACCOUNTING FOR COSTS TO SELL AND RENT, AND INITIAL RENTAL OPERATIONS OF, REAL ESTATE PROJECTS

.01 The accounting standards division has noted that diverse practices are followed in accounting for both costs to sell and costs to rent real estate projects. It has also noted that diverse practices are followed in accounting for costs and revenues during the initial operating period of a rental project, before occupancy stabilizes (sometimes referred to as the "rent-up" period). The division believes that narrowing the range of those practices is desirable. This statement of position sets forth the division's recommendations on accounting for costs to sell and costs to rent real estate projects and for initial rental operations of such projects.

.02 This statement does not apply to—

- Accounting for depreciation, carrying costs, or operations of real estate projects being accounted for as held for sale.
- "Initial direct costs" (as defined in FASB Statement no. 17, *Accounting for Leases—Initial Direct Costs*) of sales-type, operating, and other types of leases, the accounting for which is prescribed in FASB Statement no. 13.
- Costs directly related to manufacturing, merchandising, or service activities ("commercial activities") as distinguished from real estate activities.
- Real estate rental activity in which the predominant rental period is less than one month.

This statement does not modify the accounting methods for retail land sale companies as prescribed in the AICPA industry accounting guide, *Accounting for Retail Land Sales.*

.03 In the absence of contrary evidence, the representations of the owners of a real estate project concerning whether the project is held for sale or held for rental should govern the accounting for the project under the provisions of this statement. If the owners represent that a portion of a real estate project will be held for sale and a portion will be held for rental, the costs of the project should be allocated to the two portions, each of which should be accounted for as a separate project. An example of such a project would be a building with commercial facilities held for rental on its lower floors and condominium units held for sale on its upper floors. If any portion of a real estate project that the owners represented as being held for sale is rented and the rental is not clearly incidental or temporary, the unsold portion of the project should be accounted for as being held for rental.

COSTS INCURRED TO SELL REAL ESTATE PROJECTS

Present Practices

.04 Costs to sell real estate projects are accounted for in one or more of the following ways:

1. As project costs, which are capitalized as part of construction costs.
2. As prepaid expenses or deferred charges, which are deferred and amortized over future periods.
3. As period costs, which are charged to expenses as they are incurred.

The criteria governing the selection of those methods vary among companies.

Recommended Practices

.05 The following paragraphs set forth recommended criteria within the framework of present generally accepted accounting principles (see the appendix to this statement for selected accounting literature) to govern the selection of the methods described above and provide examples of the application of those criteria.

.06 *Project Costs.* Costs to sell real estate projects, less amounts recovered from incidental operations or sales, should be classified with, and accounted for in the same manner as, construction costs if they meet both of the following criteria:[1]

1. The costs are incurred (*a*) for tangible assets that are used directly throughout the selling period to aid in the sale of the project or (*b*) for services that have been performed to obtain regulatory approval for sales.
2. The costs are reasonably expected to be recovered from sales of the project or from incidental operations.

Examples of costs that ordinarily meet the criteria for project costs include the costs of model units and their furnishings, sales facilities, legal fees for preparation of prospectuses, and semipermanent signs.

.07 *Prepaid Expenses.* Costs to sell real estate projects should be accounted for as prepaid expenses if they (1) do not meet the criteria for project costs and (2) are incurred for goods or services before the goods are used or before the services are performed. Examples of costs that ordinarily meet the criteria for prepaid expenses include costs of future advertising, unused selling brochures, and commission advances. Prepaid expenses that are identifiable with specific future revenue should be charged to expenses in the periods in which the related revenue is recognized as earned. Prepaid expenses that are associated with future periods but not with specific future revenue should be charged to expenses in the periods of expected benefit.

.08 *Period Costs.* Costs to sell real estate projects that do not meet the criteria for project costs or prepaid expenses should be accounted for as period costs and charged to expenses as incurred. The benefit of those costs usually is limited to the period in which they are incurred; such costs usually provide little discernible future benefits. Examples of costs that should be accounted for as period costs include costs of advertising that have appeared in the media, sales salaries and sales overhead, and "grand openings."

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[1] For purposes of this statement, costs to sell real estate projects do not include the costs of amenities, such as golf courses and marinas.

COSTS INCURRED TO RENT REAL ESTATE PROJECTS

Present Practices

.09 At present, costs to rent real estate projects under operating leases may be deferred to future periods or charged to expenses as incurred. Generally accepted criteria to govern the choice between the two methods have not been established.

Recommended Practices

.10 The following paragraphs set forth recommended criteria within the framework of present generally accepted accounting principles (see the appendix to this statement for selected accounting literature) to govern the selection of the methods used to account for costs to rent real estate projects under operating leases and provide examples of the application of those criteria.

.11 *Rental Costs Chargeable to Future Periods.* Costs to rent real estate projects under operating leases should be deferred and charged to expenses in future periods if they are incurred for goods or services before the goods are used or before the services are performed or if they are associated with, and their recovery is reasonably expected from, future rental operations.[2] Such costs should be classified in accordance with the nature of the expenditure. Examples of costs that ordinarily should be deferred and charged to expenses in future periods include costs of model units and their furnishings, rental facilities, semipermanent signs, and unused rental brochures.

.12 Deferred rental costs that are directly related to revenue from a specific operating lease should be amortized over the lease term. Deferred rental costs that are not directly related to revenue from a specific operating lease should be amortized to expenses over the period of expected benefit; the period of amortization should begin when the project is substantially completed and held available for occupancy. Estimated unrecoverable amounts of unamortized deferred rental costs associated with a lease or group of leases should be charged to expenses when it becomes probable that the leases will be terminated.

.13 *Rental Costs Chargeable to the Current Period.* Costs to rent real estate projects that do not meet the criteria for rental costs chargeable to future periods should be accounted

[2] For the purposes of this statement, costs to rent real estate projects do not include the costs of amenities, such as golf courses and marinas.

for as period costs and charged to expenses as incurred. Examples of costs that should be accounted for as period costs include costs of advertising that has appeared in the media, rental salaries and rental overhead, and "grand openings."

INITIAL RENTAL OPERATIONS

Present Practices

.14 As previously noted, companies follow diverse practices in accounting for costs and revenues during the initial operating period of a rental project. Some consider the initial operating period to extend until a project has reached a predetermined level of occupancy, others, until certain events take place (for example, until the owners obtain permanent financing), and others, until the end of a specified period.

.15 Some companies follow the practices of capitalizing carrying costs and operating expenses net of revenues and of not recording depreciation, or of capitalizing depreciation that is recorded, until the end of the initial operating period as variously defined. They believe that reporting operating losses during the initial operating period is not appropriate when such losses are anticipated and are reasonably expected to be recovered from future rental operations.

.16 Others follow the practice of capitalizing carrying costs and operating expenses only until a rental project is capable of producing revenues and then begin recording carrying costs, depreciation, and operating expenses in operations. They believe that the rental, occupancy status, or age of a rental project should not affect the accounting for the results of operations. They believe that the operating period starts for accounting purposes once a rental project is substantially completed and held available for occupancy or is actually occupied.

Recommended Practices

.17 Certain costs incurred during construction, before a rental project is capable of producing revenue, may be capitalized, and that practice is supported by ample precedents. However, once major construction activity is completed and the project is capable of producing revenue, a rental project should be considered substantially completed and held available for occupancy. The accounting standards division believes that at that stage a change in the status of the rental project has taken place and that the owner's principal activities are substantially different from those during the construction period. Therefore, the accounting for costs and revenues should reflect the change in status of the project, as set forth in the following paragraphs.

.18 For purposes of this statement, a rental project is "substantially completed and held available for occupancy" if it meets both of the following conditions:

1. Construction has reached the stage of completion at which the builder originally intended to cease major construction activity, as distinguished from activity such as routine maintenance and cleanup.
2. Units are being or have been offered for rental.

.19 Portions of a rental project may be substantially completed and occupied by tenants or held available for occupancy, and other portions may not have reached that stage. Under those circumstances, costs incurred should be allocated between the portions under construction and the portions substantially completed and held available for occupancy, and each portion should be accounted for as a separate project.[3]

.20 Construction activity on a rental project may be suspended before the entire project is substantially completed and held available for occupancy for reasons such as insufficient rental demand. Conditions such as insufficient rental demand may indicate an impairment of the carrying value of a project that is other than temporary, whether or not they lead to suspension of construction. If it is concluded that such an impairment has occurred, an appropriate provision for losses should be recorded. Also, suspension of construction because of insufficient rental demand should, in the event carrying costs are being capitalized, cause a reevaluation of that accounting policy.

.21 The accounting standards division believes that, for a rental project that is substantially completed and held available for occupancy, rental revenues and operating costs should be recorded in income and expenses as they accrue. Amortization of costs to rent the project should be recorded in accordance with the recommendations in the section of this statement on rental costs chargeable to future periods.

[3] A portion of a rental project accounted for as a separate project is "a rental project" for the purpose of this statement.

.22 A minority of the accounting standards executive committee believes depreciation charges for a rental project that is substantially completed and held available for occupancy should be based on the greater of (1) the portion of the project that is actually rented or otherwise occupied or (2) the portion of the project that the owner anticipated would be rented based on his original projection for rental achievement. However, in the absence of persuasive evidence to the contrary, depreciation should be provided for the total rental project no later than two years following the date the rental project becomes substantially completed and held available for occupancy. The minority believes that the occupancy status of a rental project is an important factor in accounting for depreciation and that the advocated method of phasing in depreciation based on occupancy status results in a proper matching of cost and revenue as anticipated at the rental project's inception.

.23 The accounting standards division believes the useful life of a rental project begins to expire when it is substantially completed and held available for occupancy. Accordingly, at such time, depreciation on the cost of the entire project should be provided by charges to expenses.

.24 The division believes that, because of the project's changed status, all carrying costs applicable to the project, such as real estate taxes, should be charged to expense once a project is substantially completed and held available for occupancy.

TRANSITION

.25 The division recommends the application of the provisions of this statement on a prospective basis to costs to sell and costs to rent real estate projects incurred during fiscal years beginning after June 30, 1978, and for initial rental operations for projects that become substantially completed and held available for occupancy during fiscal years beginning after June 30, 1978. Earlier application is encouraged for fiscal years beginning before July 1, 1978, for which financial statements have not been issued.

APPENDIX

Selected Accounting Literature

.26 The three pervasive expense recognition principles are discussed in paragraphs 155 and 156 of Accounting Principles

Board Statement no. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises:*

> Expenses are the costs that are associated with the revenue of the period, often directly but frequently indirectly through association with the period to which the revenue has been assigned. Costs to be associated with future revenue or otherwise to be associated with future accounting periods are deferred to future periods as assets. Costs associated with past revenue or otherwise associated with prior periods are adjustments of the expenses of those prior periods. The expenses of a period are (*a*) costs directly associated with the revenue of the period, (*b*) costs associated with the period on some basis other than a direct relationship with revenue, and (*c*) costs that cannot, as a practical matter, be associated with any other period.
>
> Three pervasive expense recognition principles specify the bases for recognizing the expenses that are deducted from revenue to determine the net income or loss of a period. They are "associating cause and effect" "systematic and rational allocation," and "immediate recognition."

.27 Paragraph 161 of Accounting Principles Board Statement no. 4 discusses the application of expense recognition principles:

> To apply expense recognition principles, costs are analyzed to see whether they can be associated with revenue on the basis of cause and effect. If not, systematic and rational allocation is attempted. If neither cause and effect associations nor systematic and rational allocations can be made, costs are recognized as expenses in the period incurred or in which a loss is discerned. Practical measurement difficulties and consistency of treatment over time are important factors in determining the appropriate expense recognition principle.

.28 Associating cause and effect (often referred to as the "matching" process) is commented on in paragraph 157 of Accounting Principles Board Statement no. 4:

> Although direct cause and effect relationships can seldom be conclusively demonstrated, many costs appear to be related to particular revenue and recognizing them as expenses accompanies recognition of the revenue. Examples of expenses that are recognized by associating cause and effect are sales commissions and costs of products sold or services provided.

.29 Paragraphs 159 and 160 of Accounting Principles Board Statement no. 4 discuss the procedures followed in the absence of a presumed direct association with specific revenue:

> If an asset provides benefits for several periods, its cost is allocated to the periods in a systematic and rational manner in the absence of a more direct basis for associating cause and effect. The cost of an asset that provides benefits for only one period is recognized as an expense of that period (also a systematic and rational allocation). This form of expense recognition always involves assump-

tions about the pattern of benefits and the relationship between costs and benefits because neither of these two factors can be conclusively demonstrated. The allocation method used should appear reasonable to an unbiased observer and should be followed systematically. Examples of items that are recognized in a systematic and rational manner are depreciation of fixed assets, amortization of intangible assets, and allocation of rent and insurance. Systematic and rational allocation of costs may increase assets as product costs or as other asset costs rather than increase expenses immediately, for example, depreciation charged to inventory and costs of self-constructed assets. These costs are later recognized as expenses under the expense recognition principles.

[The immediate recognition] principle of expense recognition results in charging many costs to expense in the period in which they are paid or liabilities to pay them accrue. Examples include officers' salaries, most selling costs, amounts paid to settle lawsuits, and costs of resources used in unsuccessful efforts. The principle of immediate recognition also requires that items carried as assets in prior periods that are discovered to have no discernible future benefit be charged to expense, for example, a patent that is determined to be worthless.

.30 The term "initial direct costs" is defined in paragraph 8 of FASB Statement no. 17, *Accounting for Leases—Initial Direct Costs*, as follows:

[Initial direct costs are] those costs incurred by the lessor that are directly associated with negotiating and consummating completed leasing transactions. Those costs include, but are not necessarily limited to, commissions, legal fees, costs of credit investigations, and costs of preparing and processing documents for new leases acquired. In addition, that portion of salespersons' compensation, other than commissions, and the compensation of other employees that is applicable to the time spent in the activities described above with respect to completed leasing transactions shall also be included in initial direct costs. That portion of salespersons' compensation and the compensation of other employees that is applicable to the time spent in negotiating leases that are not consummated shall not be included in initial direct costs. No portion of supervisory and administrative expenses or other indirect expenses, such as rent and facilities costs, shall be included in initial direct costs.

Paragraph 17(*c*) of FASB Statement no. 13, *Accounting for Leases*, requires that lessors account for "initial direct costs" of sales-type leases as follows:

The present value of the minimum lease payments (net of executory costs, including any profit thereon), computed at the interest rate implicit in the lease, shall be recorded as the sales price. The cost or carrying amount, if different, of the leased property, plus any initial direct costs (as defined in paragraph 5(*m*)), less the present value of the unguaranteed residual value accruing to the benefit of the lessor, computed at the interest rate implicit in the lease, shall be charged against income in the same period.

Paragraph 18(*b*) of FASB Statement no. 13 requires that lessors account for "initial direct costs" of direct financing leases as follows:

> The difference between the gross investment in the lease in (*a*) above and the cost or carrying amount, if different, of the leased property shall be recorded as unearned income. The net investment in the lease shall consist of the gross investment less the unearned income. Initial direct costs (as defined in paragraph 5 (*m*)) shall be charged against income as incurred, and a portion of the unearned income equal to the initial direct costs shall be recognized as income in the same period. The remaining unearned income shall be amortized to income over the lease term so as to produce a constant periodic rate of return on the net investment in the lease. However, other methods of income recognition may be used if the results obtained are not materially different from those which would result from the prescribed method in the preceding sentence. The net investment in the lease shall be subject to the same considerations as other assets in classification as current or noncurrent assets in a classified balance sheet. Contingent rentals, including rentals based on variables such as the prime interest rate, shall be credited to income when they become receivable.

Paragraph 19(*c*) of FASB Statement no. 13 requires that lessors account for "initial direct costs" of operating leases as follows:

> Initial direct costs shall be deferred and allocated over the lease term in proportion to the recognition of rental income. However, initial direct costs may be charged to expense as incurred if the effect is not materially different from that which would have resulted from the use of the method prescribed in the preceding sentence.

.31 The relationship of depreciation to useful lives, and the nature of depreciation as an allocation process, not a valuation process, is noted in the definition offered in paragraph 56 of the AICPA's Accounting Terminology Bulletin no. 1, *Review and Resumé* (1953).

> *Depreciation accounting* is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. . . .

.32 Depreciation of a productive facility is described as follows in paragraph 5 of chapter 9C, Accounting Research Bulletin no. 43, *Emergency Facilities—Depreciation and Amortization.*

> The cost of a productive facility is one of the costs of the services it renders during its useful economic life. Generally accepted accounting principles require that this cost be spread over the expected useful life of the facility in such a way as to allocate it as equitably as

possible to the periods during which services are obtained from the use of the facility. This procedure is known as depreciation accounting, a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation.

.33 Accounting Research Monograph no. 1, *Accounting for Depreciable Assets*,[4] suggests implementing criteria relative to useful life for depreciation purposes:

> The estimate of "useful life" encompasses that span of time beginning after an asset is ready for use and begins to benefit the company significantly *or* when its ability to benefit the company begins to expire, and ending when the asset no longer benefits the company significantly *or* when its ability to benefit the company expires.

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[4] Charles W. Lambden, Dale L. Gerboth, and Thomas W. McRae, *Accounting for Depreciable Assets*, Accounting Research Monograph no. 1 (New York: AICPA, 1975), pp. 76-77.

Section 10,190

Statement of Position 78-4 Application of the Deposit, Installment, and Cost Recovery Methods in Accounting for Sales of Real Estate

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Section 10,190

Statement of Position 78-4 Application of the Deposit, Installment, and Cost Recovery Methods in Accounting for Sales of Real Estate

[A Proposed Recommendation to the Financial Accounting Standards Board]

AICPA

American Institute of Certified Public Accountants

1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

June 30, 1978

Donald J. Kirk, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Kirk:

The accompanying draft of statement of position, Application of the Deposit, Installment, and Cost Recovery Methods in Accounting for Sales of Real Estate, has been prepared on behalf of the accounting standards division by the AICPA's committee on real estate accounting and approved by the accounting standards executive committee.

The statement is an interpretation of the AICPA accounting guide, Accounting for Profit Recognition on Sales of Real Estate, issued in 1973. It presents the division's recommendations on the application of the deposit, installment, and cost recovery methods in accounting for sales of real estate. Diverse methods of application of those accounting methods have developed in practice, and the objective of the statement is to narrow the range of alternative practices.

Representatives of the division are available to discuss this proposal with you or your representatives at your convenience.

Sincerely,

Arthur R. Wyatt

Arthur R. Wyatt, Chairman
Accounting Standards Division

cc: Securities and Exchange Commission

NOTES

Statements of position of the AICPA accounting standards division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the accounting standards executive committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, statements of position do not establish standards enforceable under the Institute's code of professional ethics.

APPLICATION OF THE DEPOSIT, INSTALLMENT, AND COST RECOVERY METHODS IN ACCOUNTING FOR SALES OF REAL ESTATE

.01 Questions have arisen about the application of the general principles and specific conclusions set forth in the AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate,* issued in 1973. The accounting standards division addressed some of those questions in Statement of Position 75-6 [section 10,100] (December 29, 1975). This statement presents recommendations as a result of questions concerning the application of the deposit, installment, and cost recovery methods in accounting for sales of real estate, which are discussed in paragraphs 34 to 37 of the accounting guide. Diverse methods of application of those accounting methods have developed in practice. The division believes that narrowing the range of alternative practices is desirable.

THE DEPOSIT METHOD

General

.02 Accounting under the deposit method is described in paragraph 35 of the accounting guide as follows:

> The deposit method postpones recognizing a sale until a determination can be made as to whether a sale has occurred for accounting purposes. Pending recognition of the sale, the seller records no receivable but continues to show in his financial statements the property and related existing debt and discloses the status of the property. Cash received from the buyer is reported as a deposit on the contract except that portions of cash received that are designated by the contract as interest and are not subject to refund may appropriately offset carrying charges (property taxes and interest on existing debt) on the property.

.03 Except as indicated in the last sentence above, the seller's balance sheet should report all cash received from the buyer, including the initial down payment and subsequent collections of principal and interest, as a deposit (liability) on the contract. The seller's balance sheet should not report notes receivable arising from the transaction but should continue to report the property and any related mortgage debt assumed by the buyer and disclose that those items are subject to a sales contract. Nonrecourse debt assumed by the buyer should not be offset against the related property. Until the seller reports the sale, the buyer's principal payments on the mortgage debt assumed should be reported on the seller's balance sheet as additional deposits with corresponding reductions of the carrying amount of the mortgage debt.

Forfeiture of Nonrefundable Deposits

.04 When a buyer defaults or otherwise forfeits a nonrefundable deposit, the seller should credit the deposit account to income. The seller should evaluate whether the circumstances underlying the forfeiture indicate a decline in the value of the property for which an allowance for loss should be provided.

Depreciation

.05 Since, under the deposit method, the seller accounts for the property as if it were still owned, the accounting standards division believes a legal sale should not cause the seller to stop recording depreciation. While some believe that depreciation may be charged to the deposit account to the extent that the deposits are not refundable, the division believes that practice is not consistent with the concepts underlying the deposit method and that depreciation should continue to be charged to expenses as a period cost.

Provisions for Losses

.06 Under the deposit method, no sale is reported by the seller even if the terms of the transaction indicate that a loss has been incurred (for example, when the indicated sales value is less than the carrying amount of the property). The seller, however, should report the loss by a charge to income and as a valuation allowance against the property. The net carrying amount of the property, less the debt assumed by the buyer, should not exceed the sum of the recorded value of the consideration received and the fair value of the unrecorded note receivable.

.07 If, at any time after the transaction, circumstances indicate that the buyer is likely to default and the property will revert to the seller, a provision for an additional loss may be required.

Sales Recognition

.08 The seller does not report a sale and continues to use the deposit method until the conditions for recording a sale, as specified in the accounting guide, are met. Interest collected and included in the deposit account during the period before a sale is reported should be accounted for as additional sales proceeds at the time of recording the sale.[1]

THE INSTALLMENT METHOD

General

.09 When the substance of a real estate transaction indicates that a sale has occurred for accounting purposes, but collectibility of the total sales price cannot be estimated reasonably, the installment method may be appropriate unless circumstances such as those described in paragraphs 28 and 36 of the accounting guide indicate that the cost recovery method is appropriate. The installment method apportions the down payment and each subsequent collection of principal between cost recovered and profit recognized in the same ratio as cost and profit are presumed to constitute the sales value.

Debt Assumed by the Buyer

.10 In some real estate sales transactions, the buyer assumes an existing mortgage loan. If the seller is contingently liable for the assumed debt, the seller has a risk of financial loss that is similar to the risk the seller would have if the debt had not been assumed and the seller's receivable from the buyer had been increased by the amount of the debt assumed by the buyer. If the seller is not contingently liable for debt assumed by the buyer (for example, if the buyer assumes a nonrecourse mortgage loan), some believe that, as cash payments are received by the seller, the portion of the profit recognized as earned under

[1] See the section entitled "Cumulative Application of Tests When Recognition of Sale Is Delayed" in Statement of Position 75-6 [section 10,100], *Questions Concerning Profit Recognition on Sales of Real Estate.*

the installment method should be determined by the percentage of the cash received to the total cash to be received by the seller. The accounting standards division believes, however, that, for the purpose of applying the installment method, there should be no distinction between recourse and nonrecourse debt assumed by the buyer, because the seller may be motivated to honor the debt assumed by the buyer for various reasons, even though the seller is not contingently liable for the debt.

.11 Therefore, under the installment method, profit should be recognized on cash payments including principal payments by the buyer on the debt assumed and should be based on the percentage of total profit to total sales value (including the first mortgage debt assumed by the buyer). The following illustrates the calculation.

Assumptions:

Cash down payment	$ 150,000
Second mortgage payable by buyer to seller (10-year amortization of principal plus interest)	350,000
Total cash to be received by seller	500,000
First mortgage assumed by buyer (20-year amortization of principal plus interest)	500,000
Total sales price and sales value	1,000,000
Cost	600,000
Total profit	$ 400,000

The down payment is assumed to be inadequate for full profit recognition, and the installment method of accounting is assumed to be appropriate. It is also assumed that, subsequent to the down payment, the buyer pays $25,000 of principal on the first mortgage and $35,000 of principal on the second mortgage.

Profit recognition attributable to down payment:

Under the installment method, profit recognition attributable to the down payment is $60,000, representing 40 percent ($400,000 ÷ $1,000,000) of $150,000.

Profit recognition attributable to the principal payments on the first and second mortgages:

Under the installment method, profit recognition attributable to the principal payments by the buyer on the first and second mortgages is $24,000, representing 40 percent of $60,000 ($25,000 + $35,000).

Financial Statement Presentation

.12 The form of financial statement presentation under the installment method is illustrated in exhibit II, pages 31-33 of the AICPA industry accounting guide, *Accounting for Retail Land Sales* (1973). At the time of sale, the income statement should present the total sales value, from which the deferred gross profit should be deducted, and the total cost of the sale. Deferred gross profit should be presented on the balance sheet as a deduction from the related receivable. Deferred gross profit subsequently recognized as earned should be presented as a separate item of revenue on the income statement.

THE COST RECOVERY METHOD

General

.13 When the substance of a real estate transaction indicates that a sale has occurred for accounting purposes but that no profit should be recognized until costs are recovered because of the requirements of paragraphs 28 or 36 of the accounting guide, the cost recovery method must be used. In addition, the cost recovery method may be elected initially to report transactions for which the installment method is permitted.

.14 Under the cost recovery method, no profit is recognized until cash collections, including both principal and interest, and existing debt assumed by the buyer exceed the cost of the property sold.[2]

Financial Statement Presentation

.15 At the time of sale, the income statement should present the total sales value, from which the deferred gross profit should

[2] For an all-inclusive or "wrap-around" receivable held by the seller, interest collected may be recognized as income to the extent of, and as an appropriate offset to, interest expense on prior lien financing for which the seller remains responsible.

be deducted, and the total cost of the sale. Deferred gross profit should be presented on the balance sheet as a deduction from the related receivable. Principal collections should be used to reduce the related receivable. Interest collections on such receivable should be used to increase the deferred gross profit on the balance sheet. Deferred gross profit subsequently recognized as earned should be presented as a separate item of revenue on the income statement.

CHANGE FROM INSTALLMENT OR COST RECOVERY METHOD TO FULL ACCRUAL METHOD

.16 When developments subsequent to the adoption of the cost recovery or installment method provide evidence that collectibility of the sale price is reasonably assured, a change should be made to the full accrual method. In the absence of other conditions requiring deferral of profit (such as the seller's continued involvement with the property sold or a decline in its value), the remaining deferred profit should be recognized in income at that time. For example, even though a nonrecourse debt assumed by the buyer having a prior lien on the property sold is not fully paid, a seller should ordinarily change from the installment or cost recovery method to the accrual method no later than the time the seller's receivable from the buyer is collected. Another circumstance that might ordinarily, but not necessarily, provide reasonable assurance that the remaining uncollected balance of the sales price is collectible would be collection, on a cumulative basis from the date the sale was first recorded on the installment or cost recovery basis, of the aggregate cumulative amounts contemplated by paragraphs 20, 21, and 25 of the accounting guide (for this purpose collections should be in cash or the other forms of payment specified in paragraphs 22 through 24 of the guide), with the buyer's continuing investment thereafter meeting the guide's requirements.

.17 The accounting standards division believes that a change from the cost recovery or installment method of reporting profit on a sale of real estate to the full accrual method as a result of changed conditions is not a change in accounting principles. However, if the change has a material effect on the seller's financial position or results of operations, the seller's financial statements should disclose the effect of, and the reason for, recognizing as income the profit on the uncollected portion of the sales value.

TRANSITION

.18 The accounting standards division recommends the application of the provisions of this statement prospectively to transactions consummated in fiscal years beginning after June 30, 1978. Earlier application is encouraged for transactions consummated in fiscal years beginning before July 1, 1978, for which financial statements have not previously been issued.

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Section 10,200

Statement of Position 78-5
Accounting for Advance Refundings of Tax-Exempt Debt

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Section 10,200

Statement of Position 78-5 Accounting for Advance Refundings of Tax-Exempt Debt

[Proposal to Financial Accounting Standards Board]

AICPA American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

June 30, 1978

Donald J. Kirk, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Kirk:

The accompanying statement of position, Accounting for Advance Refundings of Tax-Exempt Debt, was prepared by the accounting standards division and presents the division's recommendation on the accounting for advanced refundings of debt.

Representatives of the division are available to discuss this proposal with you or your representatives at your convenience.

Sincerely,

Arthur R. Wyatt

Arthur R. Wyatt, Chairman
Accounting Standards Division

cc: Securities and Exchange Commission

NOTES

Statements of position of the AICPA Accounting Standards Division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, statements of position do not establish standards enforceable under the Institute's code of professional ethics.

ACCOUNTING FOR ADVANCE REFUNDINGS OF TAX-EXEMPT DEBT

.01 A refunding of debt is the replacement of old debt with new debt in order to obtain a perceived economic advantage. Although this perceived advantage may take various forms, it is frequently lower interest rates, a revised payment schedule, an extension of maturity dates, or the removal or modification of restrictions. An advance refunding is a refunding in which new debt is issued before the maturity or intended call date of the old debt, primarily for the purpose of replacing the old debt at a specified future date.

.02 This statement of position addresses accounting for advance refundings [1] of tax-exempt debt.[2] It is not intended to modify APB Opinion 26, *Early Extinguishment of Debt,* or FASB Statement 4, *Reporting Gains and Losses from Extinguishment of Debt.* The addendum to APB Opinion 2, "Accounting Principles for Regulated Industries," states that "differences may arise in the application of generally accepted accounting principles as between regulated and nonregulated businesses, because of the effect in regulated businesses of the rate-making process," and discusses the application of generally accepted accounting principles to regulated industries. This statement of position should be applied by entities for rate-

[1] Some advance refundings of debt involve corresponding changes in the provisions of existing leases. In this regard, see FASB Statement 22, *Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt: An Amendment of FASB Statement 13.*

[2] *Tax-exempt debt* as used here includes (1) tax-exempt debt and (2) debt (for example, a mortgage) and lease obligations that serve as collateral for tax-exempt debt.

making purposes on an individual-company-cost-of-service basis in accordance with the provisions of the addendum.

.03 Paragraphs .09 to .15 of this statement of position apply to accounting for advance refundings of tax-exempt debt including advance refundings entered into by nonprofit organizations other than state and local governmental units, that are reported in financial statements prepared in conformity with generally accepted accounting principles. Paragraphs .16 to .19 apply to state and local governmental units. Paragraph .20 sets forth appropriate disclosures, and paragraphs .21 to .23 discuss transition.

.04 The following circumstances illustrate an advance refunding of tax-exempt debt. Three years ago a corporation's capital improvements were financed by government-issued 9 percent tax-exempt industrial revenue bonds. The proceeds of the bonds were used to construct capital improvements for the corporation. The corporation's payments to the governmental unit issuer were structured in amount and timing to meet the debt service requirements of the bonds. During the past three years, interest rates in the tax-exempt bond market dropped from 9 percent to 6 percent, making it advantageous for the corporation, through the governmental unit, to replace the 9 percent debt. If the 9 percent debt is not callable, or if management does not intend to have the debt called until a future date, and the 6 percent debt is issued to replace the 9 percent issue, an advance refunding of tax-exempt debt has occurred.

.05 Advance refundings involving tax-exempt debt are subject to arbitrage rules under the Internal Revenue Code (section 103(c)) and related regulations that, in general, prohibit the yield realized from the investment of the proceeds of a new debt from exceeding the yield on the debt itself. Compliance with those rules is necessary for the interest on the debt to be exempt from federal income tax and, possibly, from state and local tax; compliance can be achieved by investing in U. S. Treasury obligations that yield a rate of interest not exceeding the yield on the new debt. The arbitrage rules do not prohibit investment in other securities so long as the yield is low enough to comply with those rules.

.06 As defined below, three methods are used to achieve advance refundings of tax-exempt debt: net advance refunding, full cash advance refunding, and crossover advance refunding.

.07 The accounting standards division believes guidance is needed concerning (*a*) the timing of income statement recognition of a gain or loss from an advance refunding, (*b*) when the refunded debt, the refunding debt, or both, along with the trust securities, should be included in the balance sheet, and (*c*) the method of income statement recognition for interest related to the debts and the trust securities.

DEFINITIONS

.08 The following definitions apply to the terms used in this statement of position:

Refunding debt (sometimes referred to as "new debt"). Debt issued to provide funds to replace the refunded debt at a specified future date(s).

Refunded debt (sometimes referred to as "old debt"). Debt for which payment at a specified future date(s) has been provided by the issuance of refunding debt.

Advance refunding. A transaction in which refunding debt is issued to replace the refunded debt at a specified future date(s), with the proceeds placed in trust or otherwise restricted to replacing the refunded debt.

Defeasance provision. A provision in the refunded debt instrument that provides the terms by which the debt may be legally satisfied and the related lien released without the debt necessarily being retired.

Defeasance. Legal satisfaction of debt under the terms of a defeasance provision.

Net advance refunding. An advance refunding in which the proceeds from the new debt, additional cash deposits, if any, and the income earned on the related investments is sufficient to pay the interest and principal on the old debt and any call premium.

Full cash advance refunding. An advance refunding in which both revenue and special obligation bonds are sold and the net proceeds plus additional cash deposits, if any, are sufficient to pay the interest and principal on the old debt and any call premium.

Special obligation bonds. Debt that is issued concurrently with revenue bonds in a full cash advance refunding, normally at a lower interest rate and with a shorter maturity date than the revenue bonds. The proceeds from the revenue and special obligation bonds are placed in trust, and the income realized from investment of the trust assets serves as collateral for, and will be used to service and retire, the special obligation bonds.

Crossover advance refunding. An advance refunding in which the proceeds from the new debt, additional cash deposits, if any, and the income earned on the related investments is sufficient to pay the principal and any call premium of the old debt and the interest on the new debt until the date of crossover. Until the date of crossover, the proceeds from the new debt serve as collateral for that debt. The old debt is serviced by the entity until the date of crossover, at which time the proceeds from the new debt are used to retire the old debt and the entity becomes obligated to service the new debt. In a crossover advance refunding, the old debt is never defeased at the time of advance refunding.

Qualifying securities. Direct U. S. Treasury obligations, securities backed by the U. S. government, or securities collateralized by U. S. government obligations.

THE DIVISION'S CONCLUSIONS

Entities Other Than State and Local Government Units

.09 *Defeasance Transactions.* The accounting standards division believes that an advance refunding in which the refunded debt is defeased results in an early extinguishment of debt because the refunded debt is legally satisfied. The gain or loss from the advance refunding should be determined in accordance with the provisions of APB Opinion 26 [3] and should be classified in accordance with FASB Statement 4. Since the old debt is legally satisfied, it is not a liability of the entity and should not be included in the balance sheet; only the new debt should be included. If special obligation bonds are issued as part of the advance refunding, they should not be presented in the balance sheet because they will be serviced from the earnings of the proceeds of the advance refunding and, therefore, represent an obligation of the trustee and not an obligation of the entity.

.10 *Nondefeasance Transactions.* The division believes that advance refundings meeting all of the following criteria are completed transactions that should be accounted for in the same

[3] See footnote 1.

manner as defeased transactions because the obligation for the refunded debt is satisfied in substance, even though in form the refunded debt is not defeased.

- The issuer is irrevocably committed to refund the old debt.
- The funds used to consummate the advance refunding are placed in an irrevocable trust with a reputable trustee for the purpose of satisfying the old debt at a specified future date(s).
- The funds used to consummate the advance refunding are invested in qualifying securities with maturities that approximate the debt service requirements of the trust.
- The invested funds used to consummate the advance refunding are not subject to lien for any purpose other than in connection with the advance refunding transaction.

.11 In an advance refunding transaction in which the refunded debt is not defeased and the criteria in paragraph .10 are not met, the division believes that the obligation for the refunded debt is not satisfied in substance, and there is no early extinguishment of debt. Consequently, no immediate gain or loss should be recognized on the transaction. However, if the retirement dates of the old debt have been established, the (1) call premium, (2) unamortized premium or discount, and (3) initial issue costs should be systematically recognized in the income statement over the remaining life of the old debt as an adjustment of the cost of borrowing related to the old debt.[4] In addition, the income earned on the funds used to consummate the advance refunding and the interest expense on both the old and new debts should be recognized in the income statement. The funds used to consummate the advance refunding should be reported as an asset, and both the old and new debts should be reported as liabilities. The assets and the liabilities should not be offset.

.12 If only a portion of the investments meet the criteria of paragraph .10, the accounting for the refunding will be partly in accordance with paragraph .10 and partly in accordance with paragraph .11. The portion of the refunded debt that would be accounted for in accordance with paragraph .10 should be based on the relationship of the cash to be provided from the investments that meet the criteria of paragraph .10 to the total cash necessary to accomplish the entire redemption of the old debt.

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[4] See footnote 1.

The balance of the refunded debt should be accounted for in accordance with paragraph .11.

.13 *Crossovers.* In a crossover, the old debt continues to be serviced by the entity until the date of the crossover. At the crossover date the old debt is retired and the entity becomes obligated to service the new debt. There is never defeasance in a crossover at the time of the advance refunding, and the accounting standards division believes that the transaction should not be treated as an in substance defeasance at that time either. Consequently, no immediate gain or loss should be recognized, and the accounting in paragraph .11 should be followed for crossover transactions.

.14 *Third Party Reimbursement to Hospitals.* If a third party is obligated to reimburse a hospital for the loss from an advance refunding, the hospital should report the loss net of the reimbursement. The portion of the reimbursement attributable to costs that cannot be claimed in the current year should be accounted for as a deferred charge and should be reduced in each subsequent year by the amount of reimbursement allowed. To the extent reimbursement is not reasonably assured, the loss should be recognized in the year incurred, and subsequent reimbursement should be recorded when received.

.15 *Income Tax Accounting.* Income tax allocation in accordance with APB Opinion 11, *Accounting for Income Taxes,* should be applied to a gain or loss as credited or charged to income in different periods for financial reporting and tax purposes.

State and Local Governmental Units

.16 *Enterprise Funds.* In accounting for an advance refunding of debt that is an obligation of an enterprise fund, the accounting recommended for entities other than state and local governmental units should be followed.

.17 *Other Than Enterprise Funds.* In advance refundings of debt in which there is defeasance or in which the criteria of paragraph .10 are met, the old debt should be removed from either the long-term debt group of accounts or the balance sheet of the affected governmental fund and be replaced by the new debt. The proceeds of the new debt should be accounted for as revenue in either the debt service fund or the affected governmental fund. The issue costs and the amount transferred to the trustee to retire the old debt should be accounted for as expenditures of the debt service fund or affected governmental fund. The amount transferred to the trustee should be shown in two parts: (1) retirement of principal and (2) gain or loss on advance refunding of debt.

.18 If the advance refunding of debt does not result in defeasance or meet the criteria in paragraph .10, the governmental unit is responsible for the new debt and remains responsible for the old debt until it is retired. Therefore, both debts should be presented in either the long-term debt group of accounts or the balance sheet of the affected governmental fund. The gross proceeds of the new debt should be recorded as revenue of either the debt service fund or other affected governmental fund; the issue costs should be recorded as an expenditure of the debt service or other affected governmental fund with the resultant net increase to a restricted fund balance. If the retirement dates of the old debt have been established, the (1) call premium, (2) unamortized premium or discount, and (3) initial issue cost should be systematically recognized in the statement of revenues and expenditures over the remaining life of the old debt as an adjustment of the cost of borrowing related to the old debt. The funds used to consummate the advance refunding should be recorded as an asset. Income earned on the funds used to consummate the advance refunding should be recorded as revenue and interest expense on both debts recorded as expenditures.

.19 In a crossover, the old debt continues to be serviced by the governmental unit until the date of the crossover. At the crossover date the old debt is retired, and the governmental unit becomes obligated to service the new debt. There is never defeasance in a crossover at the time of the advance refunding, and the accounting standards division believes that the transaction should not be treated as an in substance defeasance at that time either. Consequently, no immediate gain or loss should be recognized and the accounting in paragraph .18 should be followed for crossover transactions in a governmental unit.

DISCLOSURE

.20 Finanical statements for the period in which an advance refunding occurs should include a general description of the advance refunding, including identification of the debts involved, along with disclosures required by FASB Statement 4. A general description of the advance refunding transaction, including identification of the debts involved, should be disclosed in the financial statements for each subsequent period until the old debt and any special obligation bonds are retired.

TRANSITION

.21 This statement of position should be applied to advance refundings of debt consummated on or after July 1, 1978.

.22 If an advance refunding of debt involves a lease, this statement of position shall not be adopted retroactively for previously published annual financial statements unless it is being applied in the same manner as and concurrently with the application of FASB Statement 22.

.23 If an advance refunding of debt does not involve a lease, earlier application of the provisions of this statement of position is encouraged for advance refundings of debt consummated before July 1, 1978, but it should not be retroactively applied to advance refundings of debt consummated during fiscal years for which annual financial statements have previously been issued.

APPENDIX

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Illustration 1

Calculation of Gain or Loss in a Net Advance Refunding of Tax-Exempt Debt With Defeasance

In a net advance refunding of tax-exempt debt, the proceeds from the new debt, additional cash deposits, if any, and the income earned on the related investments are sufficient to pay the interest, principal, and call premium on the old debt. After the advance refunding, the old debt is serviced by the investments in trust and the new debt is serviced by the entity.

Assumptions

Old debt	
Principal outstanding	$50,000,000
Interest rate	9.5%
Earliest call date	5 years
Call premium	3%
Unamortized issue costs	$ 1,300,000
Unamortized discount	$ 700,000

New debt	
Principal	$60,000,000
Average coupon interest rate	5.372%
True interest cost—yield	6%
Issue costs	$ 1,507,479
Issue price	100
Period outstanding	30 years
Yield on direct U. S. Treasury obligations	6%

Calculation of New Debt

New debt and proceeds from new debt required to provide for payment of old debt

	Present value of future cash requirements at 5.372%	Earnings on direct U. S. Treasury obligations	Total future cash requirements
Call premium—old debt	$ 1,154,689	$ 345,311	$ 1,500,000
Principal—old debt	38,489,643	11,510,357	50,000,000
Interest—old debt	20,355,668	3,394,332	23,750,000
Gross proceeds of new debt	60,000,000	15,250,000	75,250,000
Debt issue costs	(1,507,479)	1,507,479	
Net proceeds to be invested	$58,492,521	$16,757,479	$75,250,000

After payment of the new debt issue costs, the proceeds from the new debt total $58,492,521. As permitted by the IRS arbitrage regulations, the direct U. S. Treasury obligations acquired with the proceeds of the new debt will yield 6 percent (to earn $16,757,479). Proposed IRS arbitrage regulations issued May 3, 1978, will exclude consideration of administrative cost in determining yield with respect to obligations issued after September 1, 1978.

Proceeds from the new debt will be sufficient to service the old debt as follows:

Present value of call premium (discounted at 6%)		$ 1,120,887
Present value of interest requirements (discounted at 6%)		20,008,728
Present value of principal (discounted at 6%)		37,362,906
Proceeds from the new debt invested in direct U. S. Treasury obligations		58,492,521
Issue costs		1,507,479
New debt		$60,000,000

Loss on Advance Refunding

New debt		$60,000,000
Issuance costs to be deferred and amortized over the life of new debt		(1,507,479)
		$58,492,521
Carrying amount of old debt		
Principal	$50,000,000	
Unamortized discount	(700,000)	
Unamortized issue costs	(1,300,000)	48,000,000
Loss on advance refunding		$10,492,521

Entries[1]

Advance refunding date		
Loss on advance refunding	10,492,521	
Deferred issue costs	1,507,479	
Old debt	50,000,000	
Unamortized discount—old debt		700,000
Unamortized issue costs—old debt		1,300,000
New debt		60,000,000
To record advance refunding of debt		
First year		
Interest expense	3,223,200	
Debt issue costs	50,250	
Deferred issue costs		50,250
Cash		3,223,200
To record amortization of debt issue costs and interest expense on new debt		

[1] These illustrative entries, as well as others that follow in this Appendix, exclude related income tax effects.

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Illustration 2

Calculation of Gain or Loss in Full Cash Advance Refunding of Tax-Exempt Debt with Defeasance

In a full cash advance refunding of tax-exempt debt, the principal amount of the revenue bonds is calculated in the same manner as in net advance refunding. Special obligation bonds are issued to provide additional funds, which, together with the proceeds from the revenue bonds, and additional cash deposits, if any, will be sufficient to pay the interest, principal, and call premium on the old debt. After the advance refunding occurs, the old debt is serviced by the investments in trust and the revenue bonds are serviced by the entity. The special obligation bonds are serviced by the income earned on the investments in trust.

Assumptions

Old debt	
Principal outstanding	$50,000,000
Interest rate	9.5%
Earliest call date	5 years
Call premium	3%
Unamortized issue costs	$ 1,300,000
Unamortized discount	$ 700,000
Revenue bonds	
Principal	$60,000,000
Average coupon interest rate	5.372%
True interest cost—yield	6%
Issue costs	$ 1,507,479
Issue price	100
Period outstanding	30 years
Yield on direct U. S. Treasury obligations [2]	6%
Special obligation bonds	
Principal	$17,150,479
Average coupon interest rate	3%
True interest cost—yield	3.5394%
Issue costs	$ 393,000
Issue price	100
Period outstanding	5 years
Yield on direct U. S. Treasury obligations [2]	3.5394%

[2] IRS arbitrage regulations require that a separate yield must be calculated on the investments acquired with the proceeds of each issue.

Calculation of New Debt

Total future cash requirements of old debt	
Principal—old debt	$50,000,000
Call premium—old debt	1,500,000
Interest—old debt	23,750,000
Total future cash requirements of old debt	$75,250,000

Proceeds from sale of new debt

	Revenue bonds	Special obligation bonds	Total
Gross proceeds from sale of debt	$60,000,000	$17,150,479	$77,150,479
Debt issue costs	(1,507,479)	(393,000)	(1,900,479)
Net proceeds to be invested	$58,492,521	$16,757,479	$75,250,000

After payment of debt issue costs, the proceeds from both issues total $75,250,000, which is sufficient to service the old debt until it is called. As permitted by the IRS arbitrage regulations, the direct U. S. Treasury obligations acquired with the proceeds of the revenue bonds and the special obligation bonds will yield 6 percent and 3.53994 percent respectively. Proposed IRS arbitrage regulations issued May 3, 1978, will exclude consideration of administrative cost in determining yield on obligations issued after September 1, 1978. The earnings on these investments will be sufficient to service the special obligation bonds as follows:

Earnings on direct U. S. Treasury obligations used to service special obligation bonds	
Earnings on proceeds of revenue bonds at 6%	$16,757,479
Earnings on proceeds of special obligation bonds at 3.5394%	2,965,570
	$19,723,049

Debt service requirements of special obligation bonds	
Principal	$17,150,479
Interest at 3%	2,572,570
	$19,723,049

Loss on Advance Refunding [3]

Revenue bonds		$60,000,000
Issuance costs to be deferred and amortized over the life of the revenue bonds		(1,507,479)
		$58,492,521
Carrying amount of old debt		
Principal	$50,000,000	
Unamortized discount	(700,000)	
Unamortized issue costs	(1,300,000)	48,000,000
Loss on advance refunding		$10,492,521

Entries

Advance refunding date		
Loss on advance refunding	10,492,521	
Deferred issue costs	1,507,479	
Old debt	50,000,000	
Unamortized discount—old debt		700,000
Unamortized issue costs—old debt		1,300,000
New debt		60,000,000
To record advance refunding of debt		
First year		
Interest expense	3,223,200	
Debt issue costs	50,250	
Deferred issue costs		50,250
Cash		3,223,200
To record amortization of debt issue costs and interest expense on new debt		

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Illustration 3

Calculation of Gain or Loss in a Net Advance Refunding of Tax-Exempt Debt When Only a Portion of the Trust Investments Meet the Criteria of Paragraph .10

In a net advance refunding of tax-exempt debt, the proceeds from the new debt, additional cash deposits, if any, and the in-

[3] The special obligation bonds are not included in the calculation of the loss on advance refunding or in the balance sheet because they will be serviced from the earnings on the proceeds from the advance refunding and do not constitute an obligation of the entity.

come earned on the related investments are sufficient to pay the interest, principal, and call premium on the old debt. After the advance refunding, the old debt is serviced by the investments in trust, and the new debt is serviced by the entity.

If only a portion of the investments meet the criteria of paragraph .10, the accounting for the refunding will be in part in accordance with paragraph .10 and in part in accordance with paragraph .11. The portion of the refunded debt that would be accounted for in accordance with paragraph .10 would be based on the relationship of the cash to be provided from the investments that meet the criteria of paragraph .10 to the total cash necessary to accomplish the entire redemption of the old debt. The balance of the refunded debt would be accounted for in accordance with paragraph .11.

Assumptions

Old debt	
Principal outstanding	$70,000,000
Interest rate	9.5%
Earliest call date	5 years
Call premium	3%
Unamortized issue costs	$ 1,820,000
Unamortized discount	$ 980,000
New debt (investment of proceeds will meet criteria of paragraph .10)	
Principal	$60,000,000
Average coupon interest rate	5.372%
True interest cost-yield	6%
Issue costs	$ 1,507,479
Issue price	100
Period outstanding	30 years
Yield on direct U. S. Treasury obligations	6%
Additional cash provided by entity (investment of cash will not meet criteria of paragraph .10)	
Cash invested in certificates of deposit	$21,606,000
Average interest rate of certificates of deposit	8%

Calculation of New Debt

New debt and proceeds from new debt required to complete the advance refunding

Total future cash requirements		
Call premium—old debt		$ 2,100,000
Principal—old debt		70,000,000
Interest—old debt		33,250,000
Total future cash requirements		105,350,000
Total future cash to be provided from certificates of deposit [4]		
Cash invested	$21,606,000	
Interest to be earned	8,494,000	30,100,000
Total future cash to be provided from proceeds of new debt		$ 75,250,000
New debt—present value of future cash to be provided from proceeds of new debt at 5.372%		$ 60,000,000
Debt issue costs		(1,507,479)
Net proceeds of new debt to be invested		$ 58,492,521

After payment of the new debt issue costs, the proceeds from the new debt total $58,492,521. As permitted by the IRS arbitrage regulations, the direct U. S. Treasury obligations acquired with the proceeds of the new debt will yield 6 percent rather than 5.372 percent, to earn the additional $1,507,479. Proposed IRS arbitrage regulations issued May 3, 1978, will exclude consideration of administrative cost in determining yield on obligations issued after September 1, 1978.

Loss on Advance Refunding

The portion of the refunded debt that would be accounted for in accordance with paragraph .10 would be based on the relationship of cash to be provided from the investments that meet the criteria of paragraph .10 to the total cash necessary to accomplish the entire redemption of the old debt.

[4] Amounts will vary depending on the specific circumstances of the refunding.

	Cash to be provided	Ratio of cash to be provided to total cash	Portion of refunded debt
Investments meeting paragraph .10 criteria	$ 75,250,000	71.429%	$50,000,000
Investments not meeting criteria	30,100,000	28.571%	20,000,000
	$105,350,000	100.000%	$70,000,000

New debt		$60,000,000
Issuance costs to be deferred and amortized over the life of the new debt		(1,507,479)
		58,492,521
Carrying amount of portion of old debt to be accounted for in accordance with paragraph .10		
Principal	$50,000,000	
Unamortized discount	(700,000)	
Unamortized issue costs	(1,300,000)	48,000,000
Loss on advance refunding		$10,492,521

Entries

Advance refunding date		
Loss on advance refunding	10,492,521	
Deferred issue costs	1,507,479	
Funds held in trust—CDs	21,606,000	
Old debt	50,000,000	
Unamortized discount—old debt		700,000
Unamortized issue costs—old debt		1,300,000
New debt		60,000,000
Cash		21,606,000
To record advance refunding of debt		
First year		
Interest expense	3,223,200	
Debt issue costs	50,250	
Deferred issue costs—new debt		50,250
Cash		3,223,200

To record amortization of debt issue costs and interest expense on new debt		
Cash	1,728,480	
Interest income from funds held in trust		1,728,480
To record interest income from certificates of deposits held in trust		
Interest expense	1,900,000	
Discount	56,000	
Debt issue costs	104,000	
Unamortized discount—old debt		56,000
Deferred issue costs—old debt		104,000
Cash		1,900,000
To record amortization of discount and debt issue costs and interest expense on $20,000,000 of old debt		
Call premium expense	120,000	
Accrued call premium payable		120,000
To systematically accrue call premium on $20,000,000 of old debt		

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The division gratefully acknowledges the contribution made to the development of this statement of position by Michael J. Walters.

Section 10,210

Statement of Position 78-6 Accounting for Property and Liability Insurance Companies

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Section 10,210

Statement of Position 78-6 Accounting for Property and Liability Insurance Companies

[Proposal to the Financial Accounting Standards Board to Amend AICPA Industry Audit Guide *Audits of Fire and Casualty Insurance Companies*]

AICPA

American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

July 28, 1978

Donald J. Kirk, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Kirk:

The accompanying statement of position, Accounting for Property and Liability Insurance Companies, has been prepared on behalf of the accounting standards division by the AICPA Insurance Companies Committee and approved by the AICPA Accounting Standards Executive Committee. It proposes amendments to the AICPA industry audit guide, Audits of Fire and Casualty Insurance Companies.

The statement of position presents the division's recommendations on significant accounting issues related to property and liability insurance companies and amends those sections of chapter 9 of Audits of Fire and Casualty Insurance Companies that discuss the accounting practices followed in the industry.

Representatives of the division are available to discuss this proposed statement of position with you or your representatives at your convenience.

Sincerely,

Arthur R. Wyatt

Arthur R. Wyatt, Chairman
Accounting Standards Division

cc: Securities and Exchange Commission

NOTE

The American Institute of Certified Public Accountants has issued a series of industry-oriented audit guides that present recommendations on auditing procedures and auditors' reports and, in some instances, on accounting principles, and a series of accounting guides that present recommendations on accounting principles. Based on experience in the application of these guides, AICPA subcommittees or task forces may from time to time conclude that it is desirable to change a guide. A statement of position is used to revise or clarify certain of the recommendations in the guide to which it relates. A statement of position represents the considered judgment of the responsible AICPA subcommittee or task force.

To the extent that a statement of position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the audit guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the subcommittee or task force.

To the extent that a statement of position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the subcommittee or task force are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the subcommittee or task force believes would be in the public interest.

ACCOUNTING FOR PROPERTY AND LIABILITY INSURANCE COMPANIES

INTRODUCTION

.01 The AICPA Insurance Companies Committee is in the process of revising the AICPA industry audit guide, *Audits of Fire and Casualty Insurance Companies* (referred to in this statement of position as the guide). The term *property and liability insurance companies* is the current terminology used to describe fire and casualty insurance companies and, therefore, is used throughout this statement of position. The committee has reviewed the section of the guide dealing with variances between (*a*) generally accepted accounting principles and (*b*) practices prescribed or permitted by insurance regulatory authorities and has identified areas in which existing practice varies, including areas in which further clarification of the guide seems necessary, and certain areas that were not discussed in the guide. This statement of position amends the guide to clarify and update those sections reviewed.

.02 A discussion memorandum was issued in November, 1975, to obtain representative views on the appropriate accounting principles to be applied in the various areas under study from AICPA members, representatives of industry, and other interested parties. An exposure draft of a proposed statement of position was issued for comments on October 31, 1977. The responses to the discussion memorandum and exposure draft were considered in the preparation of this statement of position.

.03 In recent years, accountants, investors, and other users of financial statements have expressed concern over the acceptability of accounting alternatives for similar business transactions. The accounting standards division believes that it is not desirable to have alternative accounting methods in the property and liability insurance industry. Therefore, this statement of position expresses the division's conclusions on accounting methods that should be used in the areas in which alternatives exist, except for the issues of (*a*) whether loss reserves should be discounted, which is discussed in paragraphs .34 through .41, and (*b*) whether anticipated investment income should be considered in computing premium deficiencies, which is discussed in paragraphs .22 through .30. This statement of position does not apply to title insurance. The division's conclusions on accounting for title insurance are presently being considered by the AICPA's Insurance Companies Committee *. Paragraphs .06 through .43 of this statement of position do not apply to mortgage guaranty insurance. The issues discussed in those paragraphs, as they relate to mortgage guaranty insurance, are also presently being considered by the insurance companies committee.

.04 The division's conclusions set forth in this statement of position apply to financial statements of all property and liability insurance companies that are intended to present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. Those companies include, but are not limited to, stock companies, mutual companies, and reciprocal exchanges or interinsurance exchanges.

.05 The interests of policyholders and the public in the financial integrity of the property and liability insurance companies makes it important that the solvency of those companies be continuously demonstrated to regulatory authorities. Consideration of those interests, together with the uncertainties inherent in the future, has resulted in the conservative accounting practices prescribed or permitted by insurance regulatory authorities (statutory accounting practices).[1] Federal income taxation of

* See SOP 80-1 [section 10,300], *Accounting for Title Insurance Companies.*

[1] Such practices have been prescribed by statute, regulation, or rule or have been permitted by specific approval or acceptance.

property and liability insurance companies is also based primarily on statutory accounting practices. The use of generally accepted accounting principles, as discussed in this statement of position, should not be construed as an indication that those accounting principles should also be used in reporting to regulatory or taxing authorities.

PREMIUM REVENUE RECOGNITION

Discussion

.06 Premiums are generally collected as of the inception of the contract or installment period. Under statutory accounting practices, the premiums are recognized in income evenly over the contract period, generally determined on a monthly or daily basis. That method, which was endorsed by the guide and has been generally accepted in the property and liability insurance industry, usually produces a proper association of premium revenue with losses and expenses that will be incurred over the contract period. However, some believe that a modification should be made to that basis of recognition if (*a*) the period of risk differs significantly from the contract period or (*b*) the incidence of risk, or the amount at risk, varies significantly during the contract period.

.07 For the typical policy, the premium is fixed for the period of the contract. In most cases, the fixed amount is recognized over the contract period. However, for retrospectively rated and reporting-form policies, an estimated or deposit premium is collected which is adjusted at a subsequent date, based on experience. In some cases, the deposit premium serves as a means of financing and, therefore, may only be a portion of the estimated premium. Under statutory accounting practices, those premiums are usually accounted for in the following manner: (*a*) the original estimated or deposit premium is recognized evenly over the contract period with subsequent adjustments charged or credited to income as they occur, or (*b*) the ultimate premium is estimated, revised during the contract period to reflect current experience, and recognized evenly over the contract period. The guide is silent on that subject and practice varies.

Conclusions

.08 In the insurance industry, the service provided is coverage; therefore, revenue should be recognized as that coverage is provided. The incidence of *losses* is not relevant to the recognition of revenue but is relevant to the recognition of costs, which should be recognized as losses are incurred.

.09 In most instances, premiums should be recognized as being earned evenly over the term of the insurance contract determined on a monthly or daily basis as the coverage is provided. In those few instances in which the period of risk varies significantly from the contract term, the premium should be recognized evenly over the period of risk. Also, in those few instances in which the amount of coverage declines according to a predetermined schedule, the premium should be recognized in proportion to the amount of coverage.

.10 Premium adjustments (for example, adjustments on retrospectively rated and reporting-form policies) should be accounted for on the accrual basis using an estimate of the ultimate premium. The estimated ultimate premium should be revised to reflect current experience. In those rare situations in which the ultimate premium cannot be reasonably estimated, the accrual basis should not be used.

DEFERRED ACQUISITION COSTS

Discussion

.11 The guide discusses the accounting for costs incurred in connection with writing insurance and obtaining insurance premiums. The guide indicates that statutory accounting practices, which require those costs to be charged to income as they are incurred, do not produce a proper association of costs and revenue. Therefore, the guide suggests that those costs be deferred and amortized over the contract period. That method has gained general acceptance in the industry.

.12 The guide provides little guidance on the types of acquisition costs to be deferred. As a result, the guide has been subject to differing interpretations that have resulted in variations in practices. The principal interpretations of the guide are as follows:

a. Only those costs that vary directly with and are directly related to the production of business (new and renewal premiums written) should be deferred.

b. In addition to costs that vary directly, certain costs that vary indirectly and are directly related to the production of business should be deferred.

c. All costs related to the production of business should be deferred.

.13 The guide describes only one method for estimating deferred acquisition costs referred to as "equity in unearned premiums." Some suggest that the method can distort net income if the relationship of costs incurred to premiums written varies significantly from period to period. If deferred acquisition costs are estimated based on a percentage relationship of costs incurred to written premiums, they suggest that the percentage relationship once determined, except for any adjustment related to recoverability (that is, premium deficiency as that item is described in paragraphs .17 and .18), should continue to be applied to the applicable unearned premiums throughout the term of the policies. Furthermore, they suggest that acquisition costs should be amortized using more precise methods such as those used for amortizing unearned premiums in order to associate more properly those costs with premium revenue.

Conclusions

.14 Costs that vary with and are directly related to the production of business (new and renewal premiums written during an accounting period) should be deferred and amortized to income as the related written premiums are earned. Certain expenses, such as commissions and premium taxes, vary directly with and are directly related to the production of new business and can be associated directly with specific revenue. Other expenses, such as salaries of certain employees involved in underwriting and policy issuance functions, inspection report fees, and fees paid to boards and bureaus, may vary indirectly with the production of business but are directly related to the premiums written during the period in which the costs are incurred. Those costs meet the criteria for deferral and association with the related premiums as they are earned. Certain other costs incurred during the period, such as depreciation, collection expenses and uncollectible accounts, professional fees, and general administrative expenses, do not vary directly with and are not directly related to the production of business and therefore should be expensed as incurred.

.15 To apply those expense recognition principles, costs should be analyzed to determine whether they can be associated with revenue. Arbitrary percentage allocations of expense classifications do not meet those criteria and therefore should not be used.

.16 Acquisition costs should be deferred and amortized using methods such as those used for amortizing unearned premiums in order to associate more properly those costs with premium revenue. The calculations should be made by reasonable groupings of business consistent with the company's manner of acquiring, servicing, and measuring the profitability of its insurance products. If deferred acquisition costs are calculated based on a percentage relationship of costs incurred to written premiums for a specified period of time, the percentage relationship and the time period used, once determined, should be applied to the applicable unearned premiums throughout the term of the policies, except for adjustments related to premium deficiencies.

PREMIUM DEFICIENCIES

Discussion

.17 The guide states that ". . . since the premium is expected to pay losses and expenses, and provide a margin of profit over the term of the policy, the portion measured by the unexpired term should be adequate to pay policy liabilities (principally losses and loss expenses) and return premiums during the unexpired term. . . ." In addition, the guide suggests that the premium should be adequate to recover any unamortized deferred acquisition costs. Paragraph 96 of FASB Statement no. 5 indicates that ". . . this Statement does not prohibit (and, in fact, requires) accrual of a *net* loss (that is, a loss in excess of deferred premiums) that probably will be incurred on insurance policies that are in force, provided that the loss can be reasonably estimated. . . ."

.18 The guide does not use the term "premium deficiencies" (a term adopted by the division to describe the views of the FASB, which are set forth in paragraph 96 of FASB Statement no. 5). However, with respect to evaluating the recoverability of acquisition costs to be deferred, the guide suggests that consideration be given to (*a*) the anticipated loss ratio, (*b*) the anticipated loss expense ratio, and (*c*) the anticipated ratio of expenses subsequent to acquisition. It further suggests that the determination of those anticipated ratios requires an analysis of historical data plus knowledge of other factors, such as giving greater weight to the more recent loss experience and taking into account recent rate changes that would be reflected in the unearned premiums in the balance sheet.

.19 *Determination of Premium Deficiencies.* Premium deficiencies are determinable (*a*) by individual lines of business, (*b*) by reasonable groupings of business consistent with the company's manner of acquiring, servicing, and measuring profitability of its insurance products, or (*c*) in the aggregate.

.20 *Anticipated Expenses Subsequent to Acquisition.* As stated above, the guide suggests that anticipated expenses subsequent to acquisition should be considered in evaluating the recoverability of acquisition costs to be deferred. However, the guide provides little guidance regarding what types of expenses subsequent to acquisition should be considered. The guide has been interpreted in various ways as follows:

a. Only anticipated losses, loss adjustment expenses, and unamortized deferred acquisition costs directly related to policies in force should be considered in determining premium deficiencies.

b. In addition to anticipated losses, loss adjustment expenses, and unamortized deferred acquisition costs, certain other underwriting expenses (maintenance expenses) should be considered, provided that those costs may be attributed to maintaining the policies in force.

c. Anticipated loss and loss adjustment expenses, together with all other underwriting expenses, should be considered in determining premium deficiencies.

d. Anticipated policy dividends should also be considered in the above tests.

e. Anticipated investment income should also be considered in the above tests.

.21 *Anticipated Investment Income.* The guide states that ". . . since the premium is expected to pay losses and expenses, and provide a margin of profit over the term of the policy, the portion measured by the unexpired term should be adequate to pay policy liabilities (principally losses and loss expenses) and return premiums during the unexpired term. . . ." Furthermore, the guide suggests that the premium should be adequate to recover any unamortized deferred acquisition costs. FASB

Statement no. 5, paragraph 96, requires the accrual of a *net* loss that probably will be incurred on insurance policies that are in force, provided that the loss can be reasonably estimated.

.22 The guide is silent on whether investment income should be considered in the calculation of premium deficiencies; FASB Statement no. 5 does not give specific guidance for the calculation of premium deficiencies; current practice has been not to include investment income in the determination of premium deficiencies.

.23 Some believe that the consideration of anticipated investment income in the computation of premium deficiencies is proper for the following reasons:

a. The concept of establishing premium deficiencies is founded on the generally accepted accounting principle of making provisions for foreseeable losses on contracts currently in force. That concept relates to losses on entire contracts and therefore should include all revenue and expenses relative to those contracts. An integral part of the revenue on insurance contracts is the investment income that will be earned on the funds generated by the collection of premiums in advance of the payment of losses and expenses on those contracts.

b. The concept of accruing for loss contracts, that is, premium deficiencies, differs from discounting of loss reserves in that the premium deficiency calculation relates to the estimation of future revenue and expenses relative to particular loss contracts, while the concept of discounting loss reserves relates to a currently established liability for losses incurred. Furthermore, the inclusion of investment income is a recognition of interest that will be earned on contract funds that have been collected, while the discounting of loss reserves recognizes the time value of money that relates to funds that may be in excess of the actual funds available for investment on particular loss contracts. Hence, the investment income in the premium deficiency calculation relates to actual funds available for investment, while the discounting concept imputes investment income on funds that may not necessarily have been generated by those particular contracts.

c. The incidence of recognition of investment income related to unprofitable contracts should be different from the incidence of recognition of investment income related to profitable contracts because of the nature of the contracts. The investment income on profitable contracts should be recognized as earned following the generally accepted accounting principle of not anticipating gains. However, the investment income relative to loss contracts should be used in determining the "net" loss relative to those contracts in accordance with the generally accepted accounting principle of recognizing *net* losses on unprofitable contracts. As the concept of loss recognition pertains to a "net" loss, it is contemplated that the calculation should include accrual of all anticipated costs and all anticipated revenue relative to those contracts.

.24 Others believe that anticipated investment income should be considered in the calculation of premium deficiencies for the above reasons, but that it would be inconsistent to recognize that investment income and not discount loss reserves. They believe that the recognition of the time value of money results in financial statements that are more in accord with economic reality but cannot support recognizing the effects of anticipated investment income only in the case of premium deficiencies (see paragraphs .34 through .38, "Recognition of the Time Value of Money"). They further believe that to do so would create an unnecessary difference in the application of the matching concept to profitable and unprofitable contracts. Furthermore, they point out that the methodology involved in using investment income in the computation of premium deficiencies is very similar to discounting loss reserves, and, if loss reserves were discounted, the question of using investment income in the computation of premium deficiencies would be moot.

.25 Some believe that anticipated investment income should not be considered in the calculation of premium deficiencies for the following reasons:

a. FASB Statement no. 5 defines a net loss, which the division describes as a premium deficiency, as "a loss in excess of deferred premiums." They believe that the term "deferred premiums" is intended to mean "unearned premiums" as commonly used in the insurance industry. In expanding on that view, the guide further indicates that a premium should also be adequate to recover deferred acquisition costs and expenses subsequent to acquisition. The losses and expenses referred to do not suggest that losses and expenses should be estimated any differently for that purpose than for financial statement presentation. Thus, they believe the term needs no further clarification and indicates no intention on the part of the FASB to consider investment income as a source of revenue in determining a net loss.

b. Furthermore, they believe that including investment income in the computation of premium deficiencies is not otherwise supported by current generally accepted accounting principles applicable to the determination of asset values. In testing the recoverability of asset values, they believe it may be proper to consider income *directly attributable* to that asset during the recovery period. In those cases, the income considered can be identified as being directly related to the asset being evaluated. In this situation, the asset being tested for recoverability is a deferred charge, which does not and could not generate income. The investable funds generated by the related unearned premiums cannot be segregated and identified with specific contracts. Even if a segregation were possible, they suggest one might find that contracts that are evidencing possible future deficiency problems have already consumed more funds in paying losses to date than they generated in total.

.26 *Financial Statement Presentation.* Some believe that, except in rare instances, future net losses cannot be estimated any more reasonably than catastrophes. Therefore, they believe that the provisions of the guide and FASB Statement no. 5 have little, if any, applicability in practice in this area. Others believe that, while future net losses may not be as reasonably estimable as liabilities for incurred losses, they can be estimated with sufficient reliability to determine whether there will be a net loss on the contract. Therefore, to comply with the guide and the requirements of FASB Statement no. 5, they suggest the following methods to provide for premium deficiencies:

a. A premium deficiency should first be recognized by writing off any unamortized deferred acquisition costs to the extent required. Should the premium deficiency be greater than the unamortized deferred acquisition costs, loss reserves should be provided for an additional deficiency. This method recognizes that an asset has been impaired and that the impairment should be recognized before any additional liabilities are recorded.

b. Additional loss reserves should be provided for the full amount of the premium deficiency with no adjustment to deferred acquisition costs. This method is supported by the view that the original premium contemplated the acquisition costs and that the deficiency is caused by losses in excess of those anticipated at the time premiums were established.

c. Unearned premiums should be increased by the amount of a premium deficiency. This method is supported by the view that the premium deficiency cannot be attributed to either the acquisition costs or additional losses.

Conclusions

.27 *Determination of Premium Deficiencies.* Premium deficiencies should be determined by reasonable groupings of business consistent with a company's manner of acquiring, servicing, and measuring the profitability of its insurance products.

.28 *Anticipated Expenses Subsequent to Acquisition.* In those instances in which expected losses and loss adjustment expenses, maintenance expenses, policyholder dividends, and unamortized deferred acquisition costs exceed the related unearned premiums, a provision for the anticipated premium deficiency should be provided (in accordance with FASB Statement no. 5, paragraph 96).

.29 Expected losses and loss adjustment expenses, expected policyholder dividends, and unamortized deferred acquisition costs should be considered in determining premium deficiencies. In addition, certain other underwriting expenses (maintenance expenses) should also be considered, provided those costs can be attributed to maintaining the policies in force.

.30 *Anticipated Investment Income.* Although this statement of position discusses the issue of whether anticipated investment income should be considered in computing premium deficiencies, no conclusion has been reached. Because of the importance of that issue, the division believes that it should expose for public comment its conclusions on the issue in a separate statement of position. Until the issue is resolved, companies that consider anticipated investment income in computing premium deficiencies should disclose that fact in their note on accounting policies together with the effects on the financial statements.

.31 *Financial Statement Presentation.* A premium deficiency should first be recognized by writing off any unamortized deferred acquisition costs to the extent required. Should the premium deficiency be greater than the unamortized deferred acquisition costs, a separate liability should be provided for the excess deficiency. That method recognizes that an asset has been impaired and that the impairment should be recorded before any additional liabilities are recorded.

LOSSES

Discussion

.32 *Basis of Recognition.* Under statutory accounting practices, losses are recognized as incurred. Estimated liabilities are established for losses that have been reported, and additional estimates are made for losses that have been incurred but have not yet been reported to the company. That accounting method was endorsed by the guide, has been generally accepted by industry, and is reaffirmed in FASB Statement no. 5. For losses that are historically settled over a period of years, the estimates generally include the effects of inflation and other social and economic factors on the ultimate dollar cost of settlement; the effects are generally measured using information based on historical and reasonably foreseeable events and trends.

.33 *Salvage and Subrogation.* Regulatory authorities generally do not permit recognition of estimated amounts of salvage and subrogation recoverable on paid and unpaid losses. The guide is silent on that subject and practice varies.

.34 *Recognition of the Time Value of Money.* Some regulatory authorities permit liabilities for losses to be determined based on the present value of future payments for those types of losses that are payable in fixed installments over a long period of time, such as certain workers' compensation and disability insurance claims. Discounting of loss reserves, or the recognition of the time value of money, for other types of claims not expected to be settled in one year is generally not permitted. Under generally accepted accounting principles, losses are generally recorded following statutory accounting practices. The guide is silent on that subject and practice varies.

.35 Those who believe that liabilities for losses and loss adjustment expenses should be stated at their present value suggest that investment income, excluding investment income attributable to stockholders' (members') equity, is an inextricable part of insurance operations, and present value concepts should be applied to all liabilities that are not expected to be settled in one year, provided that the period for settling the losses can be reasonably estimated. In support of that viewpoint, they cite the fact that at least fifteen states are now taking investment income into consideration in determining premium rates. They believe that further support comes from a review of the economic history of the insurance industry over the last fifty years in which investment income exceeded $29 billion (excluding investment gains of $5 billion), while underwriting losses aggregated slightly in excess of $2 billion over the same period. From that perspective, they believe it is undeniable that if the insurance industry had to depend solely on premium revenue to cover claim costs, acquisition costs, and underwriting expenses, it simply would not survive.

.36 Some believe that all liabilities for losses and loss adjustment expenses not expected to be settled in one year should be stated at their present value. Those who support that view believe that—

a. Recognition of the time value of money results in financial statements that are more in accord with economic reality than is the case without discounting. The economic history of the insurance industry and the present environment demonstrate that investment income and underwriting results are interrelated.

b. Valuing loss reserves at their present value is consistent with the generally accepted accounting principle of matching related revenue and expenses. Premium revenue would be matched against the estimated present value of claims incurred, while investment income would be matched against the interest added to the reserves. If losses are not discounted, premium revenue is matched against the estimated total amount to be paid on claims incurred, while investment income has no offset.

c. Anticipated investment income plays a significant role in determining premium rates. Premiums on lines of business in which losses are settled in a relatively short period of time are generally higher in relation to anticipated losses than premiums on lines of business in which a substantial portion of the losses are settled over a period of years.

d. Current insurance accounting principles are inconsistent, inasmuch as reserves on life, annuity, and disability policies issued by life insurance companies are discounted, while long-term reserves of property and liability insurance companies are not.

e. Although the use of present values involves estimates of the timing of future payments, the estimates would be based on historical experience modified for current trends. The use of discounted loss reserves should not imply greater precision than gross dollar reserves because all elements of the loss reserve (gross dollar value, salvage and subrogation recoverable, and payment pattern) are estimates.

.37 Those who support discounting, or the recognition of the time value of money, believe that the issue is so significant to the determination of financial position, results of operations, and changes in financial position of property and liability insurance companies that financial statements will continue to be interpreted differently until the issue is resolved.

.38 Others believe that present value concepts should be applied only to those types of losses that are payable in fixed installments over a long period of time, such as workers' compensation and other forms of disability insurance. Those who support this view believe that—

a. Those liabilities are contractual obligations to pay money on fixed or determinable dates as contemplated in APB Opinion 21, *Interest on Receivables and Payables.*

b. Present value concepts should be applied only to those types of losses because the application of present value concepts to other types of losses involve estimates of both the amounts and the timing of payments, and there is too much subjectivity inherent in establishing estimates of losses that will not be paid until some undetermined future date to permit those losses to be stated at their present value. To do so would imply a greater degree of precision than is warranted.

Conclusions

.39 *Basis of Recognition.* Under generally accepted accounting principles, losses should be recognized in the financial statements as incurred, including estimates for incurred but not reported losses. Provisions for unpaid losses should be based on the best estimate of the ultimate cost of settlement (including the effects of inflation and other social and economic factors), reduced by estimated salvage and subrogation recoveries, using past experience adjusted for current trends and any other factors that would modify past experience. Changes in loss estimates resulting from the continuous review process and differences between estimates and ultimate payments should be reflected in income of the period in which the estimates are changed.

.40 *Salvage and Subrogation.* Estimated amounts of salvage and subrogation recoverable on paid and unpaid losses should be recorded as a reduction of unpaid losses with disclosure of the amounts deducted.[2]

.41 *Recognition of the Time Value of Money.* Although this statement of position discusses the issue of whether loss reserves should be discounted, that is, whether the time value of money should be considered in determining loss reserves, no conclusion has been reached. Because of the importance of that issue, the division believes that it should expose for public comment its conclusions on the issue in a separate statement of position. Until the issue is resolved, companies that discount loss reserves or loss adjustment expenses[3] should disclose that fact in their note on accounting policies together with the effects on the financial statements.

LOSS ADJUSTMENT EXPENSES

Discussion

.42 Statutory accounting practices require that all costs associated with the settlement of losses be accrued in the period that the related losses are incurred. Those costs include amounts paid for outside services and direct, indirect, and fixed internal costs associated with the settlement of claims. No exception to that practice was presented in the guide, and the practice has been accepted in industry.

Conclusions

.43 All expenses expected to be incurred in connection with the settlement of unpaid losses should be accrued. Certain of those expenses, such as legal and adjusters' fees, can be associated directly with specific losses paid or in the process of settlement. Other of those expenses, such as the internal costs of the

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[2] The insurance companies committee has noted that this accounting practice appears to be uniform; accordingly, disclosure of the estimated amount of salvage and subrogation is considered adequate, rather than presenting the estimated amount as an asset.

[3] See paragraphs .42 and .43.

claims function, cannot be associated with specific losses but are related to losses paid or in the process of settlement.[4]

REINSURANCE

Discussion

.44 Under statutory accounting practices, amounts recoverable from reinsurers related to paid losses are classified as an asset, whereas amounts recoverable on unpaid losses and for ceded unearned premiums are offset against the related liability accounts. The guide is silent on that subject, and the practice is generally accepted in the industry. However, some believe that all amounts recoverable from reinsurers should be classified as assets, subject to appropriate valuation allowances, rather than as offsets to liability accounts on the basis that generally accepted accounting principles do not permit offsetting receivables and payables to unrelated parties.

.45 Those who support the statutory accounting practice believe that reinsurance is inextricably linked to the basic policy transaction. For example, if the amount of commercial fire coverage required exceeds the retention limit of any one company, the several companies insuring the risk could either issue separate policies for their portion of the risk or one company could issue a single policy for the total coverage and reinsure the coverage in excess of its retention limit. In either case, the net financial statement result is the same and form should not prevail over substance.

.46 Under statutory accounting practices, reinsurance premiums ceded are reported as a reduction of written and earned premiums. The guide is silent on that subject and the practice is generally accepted in the industry. Some believe the purchase of catastrophe insurance coverage by a company is not a true sharing of risk and, therefore, the premiums should be treated as operating expenses as opposed to a reduction in written and earned premiums. Those who support the statutory accounting practice believe, as stated above, that reinsurance is inextricably linked to the basic policy transaction and that a distinction cannot be made between a sharing of risk and the purchase of insurance.

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[4] See paragraph .41.

Conclusions

.47 Amounts recoverable from reinsurers that are related to paid losses and loss adjustment expenses, if applicable, should be classified in the financial statements as assets, subject to appropriate valuation allowances. Estimated amounts recoverable from reinsurers that are related to unpaid losses and loss adjustment expenses should be deducted from the unpaid losses and loss adjustment expenses with disclosure of the amounts deducted.[5] Ceded unearned premiums do not represent receivables; therefore, those amounts should be netted against the related unearned premiums. Receivables and payables from the same reinsurer, including funds withheld, should be offset. Reinsurance premiums ceded and reinsurance recoveries on losses may be netted against the respective earned premiums and incurred losses in the income statement.

.48 Companies should disclose (*a*) the nature of their reinsurance activities, (*b*) reinsurance premiums assumed and ceded that are included in or deducted from earned premiums (disclosure should also be made on a written premium basis if the difference is material), and (*c*) premiums and recoveries on catastrophe type reinsurance contracts deducted from premiums earned and losses incurred, respectively.

POLICYHOLDER DIVIDENDS AND CONTINGENT COMMISSIONS

Discussion

.49 Under statutory accounting practices—

a. Policyholder dividends are generally recorded as liabilities when declared by the board of directors.

b. Contingent commissions are recognized in financial statements on either the accrual basis, a modified cash basis (that is, accrual for commissions on expired contracts), or the cash basis.

Conclusions

.50 Generally accepted accounting principles require the use of accrual basis accounting; therefore—

[5] The insurance companies committee has noted that this accounting practice appears to be uniform; accordingly, disclosure of the estimated amount of reinsurance is adequate, rather than presenting the estimated amount as an asset.

a. Dividends should be accrued using best estimates of the amounts to be paid.

b. Contingent commissions receivable or payable should be accrued over the period during which the related profits are recognized.

VALUATION OF INVESTMENTS AND RECOGNITION OF RELATED REALIZED AND UNREALIZED GAINS OR LOSSES

Discussion

.51 Under statutory accounting practices, investments in common and preferred stocks are carried at market value, bonds are generally carried at amortized cost, mortgages are generally carried at unpaid principal, and real estate generally is carried at depreciated cost. Realized investment gains or losses are credited or charged to income. Changes in the carrying amount of investments representing unrealized appreciation or depreciation are charged or credited to stockholders' (members') equity.

.52 The statutory method of accounting for investments is supported by the following reasoning—

a. Carrying bonds whose value has not been permanently impaired at amortized cost is appropriate since a company that has the ability and intent to hold the investments to maturity will be able to realize face amount. Market values that reflect periodic changes in prevailing interest rates are irrelevant in valuing bonds that are expected to be held to maturity.

b. Carrying common and preferred stocks at market is appropriate because a company has no assurance that it will receive more or less than the current market value.

c. Including realized investment gains and losses in net income is appropriate since it is based on the realization principle. Periodic fluctuations in market value are appropriately recognized in valuing equity investments but should not be included in net income because the fluctuations do not meet the realization principle.

.53 The guide endorses the statutory basis for valuing investments. However, it suggests that realized and unrealized investment gains or losses should be combined in a separate financial statement. Those who support the separate statement approach believe that valuation of investments under the statutory method is appropriate for the reasons stated above. However, they advocate that changes in the value of investments, whether realized or unrealized, should be presented in a separate financial statement as one combined amount. They believe that the treatment is the most meaningful since the realization of a gain or loss has an offsetting effect on the related unrealized gain or loss. Because of the materiality of the amounts and the significant fluctuations that occur, realized and unrealized gains or losses should not be included in the determination of net income because they feel they would make net income meaningless.

.54 Some believe that the results of realized gains and losses should be reported as an integral part of an insurance company's results of operations because an investor's appraisal of an insurance company's performance should include the results of realized gains and losses over a period of years.

.55 FASB Statement no. 12, *Accounting for Certain Marketable Securities*, discusses the accounting treatment to be followed by specialized industries, such as property and liability insurance companies, with respect to investments in common and preferred stocks.

Conclusions

.56 Bonds should be carried at amortized cost if the company has both the ability and intent to hold the bonds until maturity and there is no decline in the market value of the bond other than a temporary decline. In those rare instances in which a company is a trader in bonds and does not intend to hold the bonds until maturity, the bonds should be carried at market; temporary fluctuations in the market value of the bonds should be recognized as unrealized gains or losses.

.57 Common and nonredeemable preferred stocks should be carried at market. Preferred stocks that by their terms must be redeemed by the issuing company should be carried at amortized cost if the company has both the ability and intention to hold the stocks until redemption and there is no decline in the market value of the stocks other than a temporary decline.

.58 Mortgages should be accounted for at unpaid principal unless collectibility is uncertain. Real estate investments should be accounted for at depreciated cost unless there is an impairment in value. Amortization, depreciation, and other related charges or credits should be charged or credited to investment income. Charges and credits to valuation accounts should be included in realized gains and losses.

.59 Realized gains and losses on all assets held for investment (including, but not limited to, stocks, bonds, mortgage loans, real estate, joint ventures, and subsidiaries held for investment) should be included in the statement of income, below operating income and net of applicable income taxes. Realized gains and losses on the sale of other assets, such as property used in the business and operating subsidiaries, should be included in the statement of income before applicable income taxes. Unrealized investment gains and losses should be recognized in stockholders' (members') equity net of applicable income taxes.

.60 If a decline in the value of an investment in a security below its cost or amortized cost is other than temporary, the investment should be written down to its net realizable value, which becomes the new cost basis. The amount of the write-down should be accounted for as a realized loss. A recovery from the new cost basis should be recognized only at the sale, maturity, or other disposition of the asset, as a realized gain.

.61 Valuation accounts are not appropriate for bonds, common stocks, or preferred stocks.

REAL ESTATE

Discussion

.62 Under statutory accounting practices, real estate is classified as an investment regardless of its use. For real estate used in operations, rent is included in investment income and is charged to the operating departments. The guide is silent on that subject, and the statutory accounting practice has gained general acceptance in the industry.

Conclusions

.63 Real estate should be classified either as an investment or as property used in the business, based on its predominant use. Depreciation and other real estate operating expenses should be classified as investment expenses or operating expenses consistent with the balance sheet classification of the related asset. Imputed investment income and rent expense should not be attributed to real estate used in the business.

ACCIDENT AND HEALTH INSURANCE

Discussion

.64 Accident and health insurance contracts are issued by both property and liability insurance companies and life insurance companies. Currently, those companies may account for their accident and health insurance contracts differently depending on which audit guide the companies follow.

Conclusions

.65 The accounting for accident and health insurance contracts should be the same irrespective of the company issuing the contracts. The applicable provisions of this statement of position should be applied to short-term accident and health insurance contracts. The provisions of the industry audit guide, *Audits of Stock Life Insurance Companies*, should be applied to long-term accident and health insurance contracts. Individual and group contracts that are noncancelable, collectively renewable, or guaranteed renewable should be considered long-term contracts. Contracts that are renewable at the option of the company (cancelable contracts) may also be considered long term if it can be demonstrated that they are likely to remain in force for a reasonable period of time, similar to guaranteed renewable contracts. All other contracts should be accounted for as short-term contracts.

TRANSITION

.66 The conclusions in this statement of position should be applied to financial statements of property and liability insurance companies issued for annual and interim periods beginning after December 31, 1978. Earlier application is encouraged. The conclusions in this statement of position should be applied retroactively, and financial statements presented for prior periods should be restated. The individual effects of changing to the accounting principles in this statement of position should be disclosed in the financial statements.

ACCOUNTING STANDARDS DIVISION

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Section 10,220

Statement of Position 78-7 Financial Accounting and Reporting by Hospitals Operated by a Governmental Unit

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Section 10,220

Statement of Position 78-7
Financial Accounting and Reporting by Hospitals Operated by a Governmental Unit

[Proposal to Financial Accounting Standards Board to Amend AICPA Industry Audit Guide on Audits of State and Local Governmental Units]

AICPA

American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

July 31, 1978

Donald J. Kirk, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Kirk:

The accompanying statement of position, Financial Accounting and Reporting by Hospitals Operated by a Governmental Unit, has been prepared by the accounting standards division.

The statement is an amendment of the AICPA Industry Audit Guide, Audits of State and Local Governmental Units, issued in 1974 and presents the division's recommendation for the accounting and reporting by hospitals operated by a governmental unit.

Representatives of the division are available to discuss this proposal with you or your representatives at your convenience.

Sincerely,

Arthur R. Wyatt

Arthur R. Wyatt, Chairman
Accounting Standards Division

cc: Securities and Exchange Commission

NOTES

Statements of position of the accounting standards division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the accounting standards executive committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, statements of position do not establish standards enforceable under the Institute's code of professional ethics.

FINANCIAL ACCOUNTING AND REPORTING BY HOSPITALS OPERATED BY A GOVERNMENTAL UNIT

.01 The AICPA Industry Audit Guide, *Hospital Audit Guide*, does not specifically address the financial accounting and reporting practices of hospitals that are operated by a governmental unit but states that the practices it discusses apply to all hospitals. The AICPA Industry Audit Guide, *Audits of State and Local Governmental Units*, effectively includes government operated hospitals within its scope. That overlap has raised questions concerning the financial accounting and reporting practices that should be followed by hospitals operated by governmental units.

.02 Different views exist about whether the financial activities of a hospital operated by a governmental unit should be accounted for as an enterprise fund or as a special revenue fund. Hospitals accounted for as enterprise funds usually follow practices comparable to those discussed in the *Hospital Audit Guide*, and hospitals accounted for as special revenue funds follow the practices discussed in *Audits of State and Local Governmental Units*. Since these accounting practices differ significantly, the accounting standards division believes that *Audits of State and Local Governmental Units* should be amended to provide for uniformity in the financial reporting of hospitals.

THE DIVISION'S CONCLUSION

.03 Some government operated hospitals have been accounted for as special revenue funds and others as enterprise funds, depending on the source of funding. The accounting standards division believes, however, that the source of revenues should not determine the accounting practices followed by hospitals. If all government operated hospitals followed the *Hospital Audit Guide* and were accounted for as enterprise funds, more comparable financial statements within the hospital industry would result. The division therefore believes that *Audits of State and Local Governmental Units* should be amended by the addition of the following paragraph (and its accompanying footnote) as the first full paragraph on page 14 of the guide.

> Hospitals that are operated by governmental units should follow the requirements of the AICPA's *Hospital Audit Guide.* Since the accounting recommended in that guide can best be accommodated in the enterprise funds, such funds should be used in accounting for governmental hospitals.*
>
> * See page 1 of the *Hospital Audit Guide* for a discussion of the types of hospitals covered.

TRANSITION

.04 This statement should be applied for fiscal years beginning after June 30, 1979. Earlier application of the statement of position is encouraged. The recommendations should be applied retroactively by prior-period adjustments, that is, reflected as adjustments of opening fund balances of the earliest years presented. When financial statements for periods before June 30, 1979, are presented, they should be restated to reflect the prior-period adjustments. The nature of the restatements and their effects should be disclosed in the period of change.

ACCOUNTING STANDARDS DIVISION

Accounting Standards Executive Committee

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Section 10,230

Statement of Position 78-8 Accounting for Product Financing Arrangements

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Section 10,230

Statement of Position 78-8 Accounting for Product Financing Arrangements

[Proposal to Financial Accounting Standards Board]

AICPA

American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

December 26, 1978

Donald J. Kirk, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, CT 06905

Dear Mr. Kirk:

The accompanying statement of position, Accounting for Product Financing Arrangements, has been prepared on behalf of the accounting standards division by the AICPA Task Force on Off-Balance-Sheet Financing Arrangements and approved by the Accounting Standards Executive Committee.

Representatives of the division are available to discuss this proposal with you or your representatives at your convenience.

Sincerely yours,

Arthur R. Wyatt

Arthur R. Wyatt
Chairman
Accounting Standards Executive Committee

cc: Securities and Exchange Commission

NOTE

Statements of position of the AICPA accounting standards division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, statements of position do not establish standards enforceable under the Institute's code of professional ethics.

ACCOUNTING FOR PRODUCT FINANCING ARRANGEMENTS

.01 A number of methods have been developed whereby an entity finances inventory of product or materials without reporting in its balance sheet the liability or the related inventory. For example, a company transfers ("sells") a product to another party and in a related transaction agrees to repurchase the product or processed goods of which the product is a component at a specified price over a specified period. The other party ("transferee" or "purchaser"), using the product and at times the financing arrangement as collateral, may borrow against the value of the product from a lending institution or other credit grantor and remit the proceeds to the company as payment for the product. As the terms of the financing arrangement are fulfilled by the company making the original transfer ("sale"), the transferee ("purchaser") reduces its borrowing from the financial institution.

.02 For transactions of that type, the accounting standards division believes guidance is necessary to determine whether the company that "sells" the product and in a related transaction agrees to repurchase the product, has in substance transferred the risks and rewards of ownership of the product. Based on that determination, a decision can be reached on whether the transferor should account for the transaction as a sale or as a financing transaction. In this document, such transactions are referred to as "product financing arrangements."

.03 Product financing arrangements include agreements in which a sponsor (the company seeking to finance product acquisition or the holding of product for future use or resale)—

a. Sells a product to another entity (the company through which the financing flows), and in a related transaction agrees to buy the product back.

b. Is a party to an arrangement whereby an entity purchases a product on the sponsor's behalf, and the sponsor in a related transaction agrees to buy the product from the entity.

c. Controls the disposition of the product that has been acquired by the other entity in accordance with the arrangements described in either (*a*) or (*b*) above.

In all of the foregoing cases, the sponsor agrees to purchase the product, or processed goods of which the product is a component, from the other entity at specified prices over specified periods or, to the extent that it does not do so, guarantees resale prices to third parties (see paragraph .04(*b*)(i) below). The Appendix contains an example of each of the types of arrangements described in (*a*) and (*b*) above.

.04 For purposes of this statement of position, product financing arrangements apply to products [1] that have been produced by or were originally acquired by the sponsor or acquired by another entity on behalf of the sponsor and have the following characteristics:

a. The financing arrangement requires the sponsor to purchase the product or processed goods of which the product is a component at specified prices. The components of the prices related to the product are not subject to future market price fluctuations except for fluctuations due to finance and holding costs. This characteristic is also present if either of the following circumstances exists:

(i) The specified prices in the financing arrangement are in the form of resale price guarantees under which the sponsor agrees to make up any difference between the specified price and the resale price for products sold to third parties or if the sponsor does not repurchase the product.

(ii) The financing arrangement is in the form of (*a*) an election (option) for the sponsor to purchase the product,

[1] Unmined or unharvested natural resources are not considered to be product for the purposes of this statement of position.

the economic effect of which compels the sponsor to purchase the product—for example, an option arrangement that provides for a significant penalty if the sponsor does not exercise the purchase election or (*b*) an election (option) whereby the other entity can require the sponsor to purchase the product.

b. The predetermined prices to be paid by the sponsor cover at least substantially all costs associated with acquisition of the product plus holding costs and including interest and any related fee charged by the other entity.

.05 Other characteristics that commonly exist in product financing arrangements but that are not necessarily present in all such arrangements are—

a. The entity that purchases the product from the sponsor or acquires it directly from a third party on behalf of the sponsor was established expressly for that purpose or is an existing trust, nonprofit entity, or credit grantor.

b. The product covered by the financial arrangement is to be used or sold by the sponsor, although a portion may be sold by the other entity directly to third parties.

c. The product subject to the financing arrangement is stored on the premises of the sponsor.

d. The debt of the other entity is guaranteed by the sponsor.

SCOPE

.06 This statement of position contains the accounting standards division's recommendations for accounting for product financing arrangements by enterprises, including nonprofit organizations, that present financial statements prepared in conformity with generally accepted accounting principles. This statement of position is not intended to modify any of the conclusions in SOP 75-1 [section 10,050], *Revenue Recognition When Right of Return Exists,* and does not apply to transactions that qualify as sales in accordance with the provisions of that statement.

PRESENT PRACTICE

.07 The products and obligations under product financing arrangements are sometimes reported as assets and liabilities in the financial statements of the sponsor, but often they are not, although the obligations are sometimes disclosed as commitments. Often, financing and holding costs incurred by the other entity are not reported by the sponsor until the product is acquired from the other entity. Those costs are sometimes considered part of product cost irrespective of the sponsor's accounting for similar costs applicable to its products that are not subject to a product financing arrangement.

THE DIVISION'S CONCLUSION

.08 The division believes that, in substance, the sponsor of a product financing arrangement that demonstrates all of the characteristics described in paragraph .04 bears substantially all of the risks and rewards of ownership of the product. The assets and related liabilities that result from such product financing arrangements should be reported in the financial statements of the sponsor.

.09 Products and obligations under product financing arrangements that contain all the characteristics described in paragraph .04 should be accounted for by the sponsor as follows:

a. If a sponsor sells a product to another entity and, in a related transaction, agrees to buy back the product or processed goods of which the product is a component the sponsor should record a liability at the time the proceeds are received from the other entity to the extent that the product is covered by a financing arrangement. The sponsor should not record the transaction as a sale and should not remove the product from its balance sheet except for product not covered by a financing arrangement. Such a product financing arrangement, despite its form, does not in substance represent a sale or purchase by the sponsor, but rather a method of financing its product.

b. If the sponsor is a party to an arrangement whereby an entity buys a product on the sponsor's behalf and, in a related transaction, the sponsor agree to buy the product or processed goods of which the product is a component from the entity, the sponsor should record the asset and the related obligation when the product is acquired by the other entity.

.10 Costs of the product, excluding processing charges, in excess of the sponsor's original production or purchase cost or the other entity's acquisition costs represent financing and holding costs. The sponsor should account for such costs in accordance with its applicable accounting policies when the costs are incurred by the other entity. For example, if insurance and other holding costs are ordinarily treated as period costs by the sponsor, similar costs associated with the product covered by financing arrangements should be accrued and expensed as period costs by the sponsor as incurred by the other entity.

TRANSITION

.11 An accounting change to adopt the recommendations of this statement of position should be made for balance sheets as of December 20, 1979, and later. Early adoption of these recommendations and retroactive application are encouraged.

.12 The nature of the change in an enterprise's financial statements resulting from application of this statement should be disclosed.

APPENDIX

.13 Examples of a Product Financing Arrangement

Two cases are presented to illustrate application of the recommendations expressed in paragraphs .08 through .10. The facts assumed in the cases are illustrative only and are not intended to modify or limit in any way the recommendations in paragraphs .08 through .10. The facts assumed in each case could vary in one or more respects without altering the accounting recommendations.

Case 1

"Sale" and related agreement to repurchase (paragraph .03(*a*)).

Facts

A company (sponsor) arranges for an entity to acquire a portion of its inventory. The entity's sole asset is the transferred inventory that is in turn used as collateral for bank financing. The proceeds of the bank financing are then remitted to the sponsor. The debt of the entity is guaranteed by the sponsor. The inventory is stored in a public warehouse during the holding period. The company, in connection with the "sale" (legal title passes to the entity), enters into a financing arrangement under which—

a. The company agrees to pay all costs of the entity associated with the inventory including holding and storage costs.

b. The company agrees to pay the entity interest on the purchase price of the inventory equivalent to the interest and fees incurred in connection with the bank financing.

c. The company agrees to repurchase the inventory from the entity at a specified future date for the same price originally paid by the entity to acquire the inventory irrespective of changes in market prices during the holding period.

d. The entity agrees not to assign or otherwise encumber the inventory during its ownership period, except to the extent of providing collateral for the bank financing.

Accounting Treatment

In the product financing arrangement outlined above, all of the characteristics in paragraph .04 are present; accordingly, the company should neither record the transaction as a sale of inventory nor remove the inventory from its balance sheet. The company should record a liability at the time the proceeds are received from the entity. Financing and holding costs should be accrued by the company as incurred by the entity and treated in accordance with the company's normal accounting policies for such costs.

Case 2

A sponsor arranges for an entity to buy product on the sponsor's behalf with a related agreement to purchase the product from the entity (paragraph .03(*b*)).

Facts

A company (sponsor) arranges for a newly created trust to acquire on its behalf an existing supply of fuel. In a related agreement, the sponsor agrees to buy the fuel from the entity over a specified period and at specified prices. The prices established are adequate to cover all holding and financing costs of the trust. The trust finances the purchase of fuel using the fuel and the agreement as collateral.

Accounting Treatment

In the product financing arrangement outlined above, all of the characteristics in paragraph .04 are present; accordingly, the sponsor should report the asset (fuel) and the related liability in its financial statements when the fuel is acquired by the other entity (time of acquiring the fuel). Financing and holding costs should be accrued by the sponsor as incurred by the trust and treated in accordance with the sponsor's accounting policies for holding and financing costs related to inventory items.

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[Proposal to Financial Accounting Standards Board]

AICPA American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

December 29, 1978

Donald J. Kirk, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Kirk:

The accompanying statement of position, Accounting for Investments in Real Estate Ventures, has been prepared on behalf of the division by the AICPA Committee on Real Estate Accounting and approved by the AICPA Accounting Standards Executive Committee.

The statement presents the division's recommendations on accounting for investments in real estate ventures (corporate joint ventures, general and limited partnerships, and undivided interests). The recommendations are primarily an application of the existing authoritative accounting literature to the specialized accounting problems related to such investments and are intended to narrow the range of alternative practices.

Representatives of the division are available to discuss this proposal with you or your staff at your convenience.

Sincerely,

Arthur R. Wyatt

Arthur R. Wyatt
Chairman
Accounting Standards Division

cc: Securities and Exchange Commission

NOTE

Statements of position of the accounting standards division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the accounting standards executive committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, statements of positions do not establish standards enforceable under the Institute's code of professional ethics.

ACCOUNTING FOR INVESTMENTS IN REAL ESTATE VENTURES

INTRODUCTION

.01 Ownership of real estate or real estate development projects by two or more entities may take several forms. The most common forms are as follows:

a. *A corporate joint venture*—a corporation owned and operated by a small group of ventures to accomplish a mutually beneficial venture or project, as described in paragraph 3 of APB Opinion 18.

b. *A general partnership*—an association in which each partner has unlimited liability.

c. *A limited partnership*—an association in which one or more general partners have unlimited liability and one or more partners have limited liability. A limited partnership is usually managed by the general partner or partners, subject to limitations, if any, imposed by the partnership agreement.

d. *An undivided interest*—an ownership arrangement in which two or more parties jointly own property, and title is held individually to the extent of each party's interest.

In this statement of position, the terms *real estate venture* and *venture* apply to all of the ownership arrangements described in this paragraph.

.02 These forms of ownership differ in legal form and economic substance, and the authoritative accounting literature dealing with the specialized accounting problems related to such investments is limited. In practice, those accounting problems are dealt with in a variety of ways, and the division believes narrowing the range of those alternative practices is desirable.

.03 This statement of position presents the division's recommendations on accounting for investments in real estate ventures in financial statements prepared in conformity with generally accepted accounting principles. It does not apply to regulated investment companies and other entities that are required to account for investments at quoted market value or fair value.

THE APPLICABILITY OF THE EQUITY METHOD OF ACCOUNTING

Corporate Joint Ventures

.04 APB Opinion 18 requires investments in corporate joint ventures to be accounted for by the equity method and includes guidance for applying that method in the financial statements of the investor. That opinion applies to corporate joint ventures created to own or operate real estate projects.

.05 Paragraph 3 of APB Opinion 18 states that "an entity which is a subsidiary of one of the 'joint venturers' is not a corporate joint venture." A subsidiary, according to that opinion, refers to

> . . . a corporation which is controlled, directly or indirectly, by another corporation. The usual condition for control is ownership of a majority (over 50 percent) of the outstanding voting stock. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree.

Accordingly, an investment in a corporate subsidiary that is a real estate venture should be accounted for by the investor-parent using the principles applicable to investments in subsidiaries rather than those applicable to investments in corporate joint ventures. Minority shareholders in such a real estate venture should account for their investment using the principles applicable to investments in common stock set forth in APB Opinion 18 or in FASB Statement no. 12.

General Partnerships

.06 The staff of the American Institute of Certified Public Accountants issued an interpretation of APB Opinion 18 in November, 1971, which concludes that many of the provisions of APB Opinion 18 are appropriate in accounting for investments in certain unincorporated entities. The division believes that the principal difference, aside from income tax considerations, between corporate joint ventures and general partnerships is that the individual investors in general partnerships usually assume joint and several liability. The division believes, however, that the equity method enables noncontrolling investors in general partnerships to reflect the underlying nature of their investments in those ventures as well as it does for investors in corporate joint ventures. Accordingly, the division believes that investments in noncontrolled real estate general partnerships should be accounted for and reported under the equity method. This recommendation requires the one-line equity method of presentation in both the balance sheet and the statement of income.[1] Paragraph 19 of APB Opinion 18 should be used as a guide in applying the equity method. Investors in general partnerships should provide for income taxes on the profits accrued on their investment in the partnership regardless of the tax basis used in the partnership return. The tax liabilities applicable to partnership interests relate directly to the partners, and the accounting for income taxes generally contemplated by APB Opinion 11 is appropriate. Thus, the differences, if any, between income or loss recorded by a partner under the equity method and the partner's share of distributable taxable income or loss from the partnership should be accounted for as timing differences unless they result from tax-exempt revenues or other permanent differences.

.07 The division believes a general partnership that is controlled, directly or indirectly, by an investor is, in substance, a subsidiary of the investor. APB Opinion 18 states that the usual condition for control of a corporation is ownership of a majority (over 50 percent) of the outstanding voting stock. However, if partnership voting interests are not clearly indicated, a condition that would usually indicate control is ownership of a majority (over 50 percent) of the financial interests in profits or losses (see paragraph .25). The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other partners, or by court decree. On the other hand, majority ownership may not constitute control if major decisions such as the acquisition, sale, or

[1] Pro rata consolidation is not appropriate except in the limited circumstances described in paragraph .11.

refinancing of principal partnership assets must be approved by one or more of the other partners. The division believes that a controlling investor should account for its investment under the principles of accounting applicable to investments in subsidiaries. Accordingly, intercompany profits and losses on assets remaining within the group should be eliminated. A noncontrolling investor in a general partnership should account for its investment by the equity method and should be guided by the provisions of paragraph 19 of APB Opinion 18.

Limited Partnerships

.08 The division believes that the accounting recommendations for use of the equity method of accounting for investments in general partnerships are generally appropriate for accounting by limited partners for their investments in limited partnerships. A limited partner's interest may be so minor that the limited partner may have virtually no influence over partnership operating and financial policies. Such a limited partner is, in substance, in the same position with respect to the investment as an investor that owns a minor common stock interest in a corporation, and, accordingly, accounting for the investment using the cost method may be appropriate. Under the cost method, income recognized by the investor is limited to distributions received, except that distributions that exceed the investor's share of earnings after the date of the investment are applied to reduce the carrying value of the investment. Also, differences between income or losses recognized for financial reporting purposes and the investor's share of taxable income or losses should be accounted for as timing differences unless they result from tax-exempt revenues or other permanent differences.

.09 The rights and obligations of the general partners in a limited partnership are different from those of the limited partners. Some believe that general partners should be deemed to have the controlling interest in a limited partnership. However, if limited partners have important rights, such as the right to replace the general partner or partners, approve the sale or refinancing of principal assets, or approve the acquisition of principal partnership assets, the partnership may not be under the control, directly or indirectly, of the general partnership interests. The division believes that the general partners are in control and should account for their investments in accordance with the recommendations in paragraph .07 only if the substance of the partnership or other agreements provides for control by the general partners.

.10 The division believes that if the substance of the partnership arrangement is such that the general partners are not in control of the major operating and financial policies of the partnership, a limited partner may be in control. An example could be a limited partner holding over 50 percent of the total partnership interest. A controlling limited partner should be guided in accounting for its investment by the principles for investments in subsidiaries. Noncontrolling limited partners should account for their investments by the equity method and should be guided by the provisions of paragraph 19 of APB Opinion 18, as discussed in paragraphs .06 and .07, or by the cost method, as discussed in paragraph .08, as appropriate.

Undivided Interests

.11 In an interpretation of APB Opinion 18 issued by the staff of the American Institute of Certified Public Accountants in November, 1971, the staff concluded that most of the provisions of paragraph 19 of APB Opinion 18 generally would be appropriate in accounting for partnerships and unincorporated ventures, but that if

> . . . the investor-venturer owns an undivided interest in each asset and is proportionately (i. e., severally) liable for its share of each liability, the provisions of the equity method set forth in paragraph 19(c) of the Opinion may not apply in some industries. For example, where it is the established industry practice . . ., the investor-venturer may account in its financial statements for its *pro rata* share of the assets, liabilities, revenues, and expenses of the venture.

If real property owned by undivided interests is subject to joint control by the owners, the division believes that investor-venturers should not present their investments by accounting for their pro rata share of the assets, liabilities, revenues, and expenses of the ventures. Such property is subject to joint control if decisions regarding the financing, development, sale, or operations require the approval of two or more of the owners. Most real estate ventures with ownership in the form of undivided interests are subject to some level of joint control. Accordingly, the division believes that such investments should be presented in the same manner as investments in noncontrolled partnerships. If, however, the approval of two or more of the owners is not required for decisions regarding the financing, development, sale, or operations of real estate owned and each investor is entitled to only its pro rata share of income, is responsible to pay only its pro rata share of expenses, and is severally liable only for indebtedness it incurs in connection with its interest in the property, the investment may be presented by recording the undivided interest in the assets, liabilities, revenue, and expenses of the venture.

GENERAL MATTERS

Disclosure

.12 The division believes that investors in real estate ventures should be guided by the provisions of paragraph 20 of APB Opinion 18 in determining the disclosures to be made in their financial statements.

Statement of Changes in Financial Position

.13 APB Opinion 19, which governs the form and content of statements of changes in financial position, requires disclosure of working capital or cash provided from operations. The investor's share of a real estate venture's earnings reported under the equity method, to the extent that such earnings are not distributed in the period earned, should not be included in the amount reported as working capital or cash provided by operations, except to the extent distributions should be accrued as a current receivable under generally accepted accounting principles.

INVESTOR ACCOUNTING FOR LOSSES

General

.14 Some investors have suggested that their equity in losses of a real estate venture need not be recorded under the equity method of accounting as long as the value of their investment has not been impaired; for example, if it is expected that the venture's assets can be sold for more than their carrying value. The division believes that investors should record their share of the real estate venture's losses, determined in conformity with generally accepted accounting principles, without regard to unrealized increases in the estimated fair value of the venture's assets.

Accounting for an Investor's Share of Losses in Excess of Its Investment, Including Loans and Advances

.15 The division believes that an investor that is liable for the obligations of the venture or is otherwise committed to provide additional financial support to the venture should record its equity in real estate venture losses in excess of its investment, including loans and advances.[2] The following are examples of such circumstances:

a. The investor has a legal obligation as a guarantor or general partner.

b. The investor has indicated a commitment, based on considerations such as business reputation, intercompany relationships, or credit standing, to provide additional financial support. Such a commitment might be indicated by previous support provided by the investor or statements by the investor to other investors or third parties of the investor's intention to provide support.

.16 An investor in a real estate venture should report its recorded share of losses in excess of its investments, including loans and advances, as a liability in its financial statements.

.17 If an investor does not recognize venture losses in excess of its investment, loans, and advances and the venture subsequently reports net income, the investor should resume applying the equity method only after its share of such net income equals the share of net losses not recognized during the period in which equity accounting was suspended.

.18 If it is probable that one or more investors cannot bear their share of losses, the remaining investors should record their proportionate shares of venture losses otherwise allocable to investors considered unable to bear their share of losses.[3] When the venture subsequently reports income, those remaining investors should record their proportionate share of the venture's net income otherwise allocable to investors considered unable to bear their share of losses until such income equals the excess

[2] An investor, though not liable or otherwise committed to provide additional financial support, should provide for losses in excess of investment when the imminent return to profitable operations by the venture appears to be assured. For example, a material nonrecurring loss of an isolated nature, or start-up losses, may reduce an investment below zero though the underlying profitable pattern of an investee is unimpaired.

[3] This recommendation does not apply for real property jointly owned and operated as undivided interests in assets if the claims or liens of the investor's creditors are limited to the investors' respective interests in such property.

losses they previously recorded. The division also believes that an investor who is deemed by other investors to be unable to bear its share of losses should continue to record its contractual share of losses unless it is relieved from the obligation to make payment by agreement or operation of law.

.19 The division believes that the accounting by an investor for losses otherwise allocable to other investors should be governed by the provisions of FASB Statement no. 5 relating to loss contingencies. Accordingly, the investor should record a proportionate share of the losses otherwise allocable to other investors if it is probable that they will not bear their share. In this connection, the division believes that each investor should look primarily to the fair value of the other investors' interests in the venture and the extent to which the venture's debt is nonrecourse in evaluating their ability and willingness to bear their allocable share of losses.[4] However, there may be satisfactory alternative evidence of an ability and willingness of other investors to bear their allocable share of losses. Such evidence might be, for example, that those investors previously made loans or contributions to support cash deficits, possess satisfactory financial standing (as may be evidenced by satisfactory credit ratings), or have provided adequately collateralized guarantees.

Loss in Value of an Investment, Including Loans and Advances, Other Than a Temporary Decline

.20 A loss in value of an investment, including loans and advances, other than a temporary decline should be recognized under the accounting principles that apply to a loss in value of long-term assets. Such a loss in value may be indicated, for example, by a decision by other investors to cease providing support or reduce their financial commitment to the venture.

OTHER ACCOUNTING MATTERS RELATED TO THE USE OF THE EQUITY METHOD

Eliminating Interentity Profits and Losses

.21 As noted elsewhere in this statement, APB Opinion 18 should be used as a guide when applying the equity method. Paragraph 19(a) of that opinion provides that, in applying the

[4] An investor may not be able to apply the general rule to an investment in an undivided interest because the extent to which the interests of other investors are encumbered by liens may not be known.

equity method, intercompany profits and losses should be eliminated until realized by the investor or investee as if the investee company were consolidated. The division believes that intercompany profit should be eliminated by the investor in relation to the investor's ownership interest in the investee, except that an investor that controls the investee and enters into a transaction with the investee should eliminate all of the intercompany profit on assets remaining within the group.

.22 The AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate,* sets out similar rules in paragraph 58:

> A sale of property in which the seller holds or acquires an equity interest in the buyer should result in recognizing only the part of the profit proportionate to the outside interest in the buyer. No profit should be recognized if the seller controls the buyer . . . until realized from transactions with outside parties through sale or operations of the property.

.23 The division believes that if a transaction with a real estate venture confirms that there has been a loss in the value of the asset sold that is other than temporary and that has not been recognized previously, the loss should be recognized on the books of the transferor.

Accounting Principles Used by the Venture

.24 In the real estate industry, the accounts of a venture may reflect accounting practices, such as those used to prepare tax basis data for investors, that vary from generally accepted accounting principles. If the financial statements of the investor are to be prepared in conformity with generally accepted accounting principles, such variances that are material should be eliminated in applying the equity method.

Allocation Ratios for the Determination of Investor Income

.25 Venture agreements may designate different allocations among the investors of the venture's (*a*) profits and losses, (*b*) specified costs and expenses, (*c*) distributions of cash from operations, and (*d*) distributions of cash proceeds from liquidation. Such agreements may also provide for changes in the allocations at specified times or on the occurrence of specified events. Accounting by the investors for their equity in the venture's earnings under such agreements requires careful consideration of substance over form and consideration of underlying values as discussed in paragraph .19. The division believes that in order to determine the investor's share of venture net income or loss, such agreements or arrangements should be analyzed to determine how an increase or decrease in net assets of the venture (determined in conformity with generally accepted accounting principles) will affect cash payments to the investor over the life of the venture and on its liquidation. The division believes that specified profit and loss allocation ratios should not be used to determine an investor's equity in venture earnings if the allocation of cash distributions and liquidating distributions are determined on some other basis. For example, if a venture agreement between two investors purports to allocate all depreciation expense to one investor and to allocate all other revenues and expenses equally, but further provides that irrespective of such allocations, distributions to the investors will be made simultaneously and divided equally between them, there is no substance to the purported allocation of depreciation expense.

Accounting for a Difference Between the Carrying Amount of an Investment in a Real Estate Venture and the Underlying Equity in Net Assets

.26 Differences between the carrying amount of an investment in a real estate venture and the investor's equity in the underlying net assets recorded by the venture may arise, for example, from unrecognized profit on transfers of real estate to the venture or differences in accounting methods. In addition, differences may arise from the acquisition of an investment in a venture at a price different from the investor's share of the net assets as recorded on the books of the venture.

.27 Differences that arise from a business combination with a venture accounted for as a purchase should be accounted for in accordance with the provisions of APB Opinion 16. The division believes than an excess of the cost of the investment acquired over the equity in the underlying net assets usually would be ascribed to the fair values of real property interest owned by the venture. Any cost in excess of amounts assigned to identifiable tangible or intangible assets acquired is an intangible asset that should be amortized in a systematic manner related to the purpose of the venture. Because of the limited life and limited purpose usually inherent in real estate ventures, the division believes that the benefits from such an intangible asset generally decline as the property is sold or depreciated, and therefore amortization of that intangible asset should be recorded in relation to cost of sales or depreciation. The period of amortization should not, however, exceed forty years.

.28 Paragraph 19(b) of APB Opinion 18 provides that the difference between the cost of an investment and the amount of the underlying equity in net assets of the investee "should affect the determination of the amount of the investor's share of earnings or losses of an investee as if the investee were a consolidated subsidiary." The differences should be recognized by the investor as an adjustment to the amount of the venturer's depreciation, cost of sales, or other expenses, as appropriate, in recording income or loss from the venture on the equity basis.

ACCOUNTING BY THE INVESTOR FOR CERTAIN TRANSACTIONS WITH A REAL ESTATE VENTURE

Capital Contributions

.29 *Contribution of Cash.* If all investors contribute cash at the formation of the real estate venture, each investor should record its investment at the amount of the cash contributed.

.30 *Contribution of Real Estate.* The division believes an investor that contributes real estate to the capital of a real estate venture generally should record its investment in the venture at the investor's cost (less related depreciation and valuation allowances) of the real estate contributed, regardless of whether the other investors contribute cash, property, or services. The division believes that an investor should not recognize profit on a transaction that in economic substance is a contribution to the capital of an entity, because a contribution to the capital of an entity is not the culmination of the earnings process. The division understands, however, that some transactions, structured in the form of capital contributions, may in economic substance be sales. The recommendations in paragraph .36 of this statement on accounting for sales of real estate to a venture by an investor apply to those transactions.

An example of such a transaction is one in which investor *A* contributes to a venture real estate with a fair value of $2,000 and investor *B* contributes cash in the amount of $1,000 which is immediately withdrawn by investor *A*, and, following such contributions and withdrawals, each investor has a 50 percent interest in the venture (the only asset of which is the real estate). Assuming investor *A* is not committed to reinvest the $1,000 in the venture, the substance of this transaction is a sale by investor *A* of a one-half interest in the real estate in exchange for cash. A minority of the division disagrees with the conclusion that an investor contributing real estate to a real estate venture should record its investment at the cost of the real estate contributed. They believe that profit recognition by such an investor to the extent of the other investors' interests in the profits and losses of the venture may be appropriate if the other investors contribute cash or other hard assets (such as marketable securities) for their interests and the investor contributing the real estate has no continuing involvement with the real estate that would require deferral of profit under the AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate*. The majority of the division believes that unless the investor that contributes real estate to the venture withdraws cash (or other hard assets) and has no commitment to reinvest, such a transaction is not the culmination of an earnings process.

.31 An investor contributing property to a venture may obtain a disproportionately small interest in the venture based on a comparison of the carrying amount of the property with the cash contributed by the other investors. That situation might indicate that the investor contributing the property has suffered a loss that should be recognized.

.32 *Contribution of Services or Intangibles.* The division believes the accounting considerations that apply to real property contributed to a partnership or joint venture also apply to contributions of services or intangibles. The investor's cost of such services or intangibles to be allocated to the cost of the investment should be determined by the investor in the same manner as for an investment in a wholly owned real estate project.

Income From Loans or Advances to a Venture

.33 Interest on loans and advances that are in substance capital contributions (for example, if all the investors are required to make loans and advances proportionate to their equity interests) should be accounted for as distributions rather than as interest income by the investors.

.34 An investor-lender that does not capitalize interest on its own real estate construction and development projects should account for interest on loans and advances that are not in substance capital contributions in accordance with the recommendations in this paragraph.

a. All interest income on the investor's loans or advances to the venture should be deferred if either of the following conditions is present.

(i) Collectibility of the principal or interest is in doubt. This condition may exist if adequate collateral and other terms normally required by an independent lender are not present.

(ii) There is a reasonable expectation that the other investors will not bear their shares of losses, resulting in uncertainty as to the lender's share of the venture's related interest expense.

b. If neither of the conditions in (*a*) is present and either the venture has recorded interest as an expense or the venture has capitalized the interest but in order to conform to the investor's accounting policies, the investor has recorded its equity in the income or loss of the venture as if the venture had charged the interest to expense, the entire interest income accrued on loans or advances to a venture should be recorded as earned.

c. If the conditions in (*a*) or (*b*) are not present, a portion of interest income from loans and advances to a venture should be deferred based on the investor's percentage interest in the profits and losses of the venture. However, an evaluation similar to that discussed in paragraphs .18 and .19 for recording the investor's share of losses should be made to avoid recording as interest income amounts that may ultimately be borne as losses by the investor making the loan.

.35 Pending completion of the Financial Accounting Standard Board's interest project, the division makes no recommendation on accounting for interest income from loans or advances to a real estate venture by an investor that capitalizes interest on its own real estate and development projects.

Sales of Real Estate to a Venture

.36 Sales of real estate by an investor to a real estate venture are subject to all of the provisions set forth in the AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate.*

Sales of Services to a Venture

.37 If services are performed for a venture by an investor and their cost is capitalized by the venture, profit may be recognized by the investor to the extent attributable to the outside interests in the venture if the following conditions are met:

a. The substance of the transaction does not significantly differ from its form.

b. There are no substantial uncertainties about the ability of the investor to complete performance (as may be the case if the investor lacks experience in the business of the venture) or the total cost of services to be rendered.

c. There is a reasonable expectation that the other investors will bear their share of losses, if any.

The method of recognizing income from services rendered should be consistent with the method followed for services performed for unrelated parties.

Purchases of Real Estate or Services From a Venture

.38 An investor should not record as income its equity in the venture's profit from a sale of real estate to that investor; the investor's share of such profit should be recorded as a reduction in the carrying amount of the purchased real estate and recognized as income on a pro rata basis as the real estate is depreciated or when it is sold to a third party. Similarly, if a venture performs services for an investor and the cost of those services is capitalized by the investor, the investor's share of the venture's profit in the transaction should be recorded as a reduction in the carrying amount of the capitalized cost.

ACCOUNTING FOR THE SALE OF AN INTEREST IN A REAL ESTATE VENTURE

.39 The division believes that a sale of an investment in a real estate venture (including the sale of stock in a corporate real estate venture) is the equivalent of a sale of an interest in the underlying real estate and should be evaluated under the guidelines set forth in the AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate.*

.40 Subject to the provisions of paragraph .39, an investor should recognize a gain or loss on a sale of its investment in a real estate venture equal to the difference at the time of sale between the selling price and the investor's carrying amount of the portion of the investment sold. Deferred taxes related to timing differences should be recognized.

TRANSITION

.41 The division recommends applying this statement of position to financial statements issued for fiscal years and interim periods beginning after December 24, 1978. Adjustments resulting from a change in accounting method to comply with the recommendations in this statement should be applied retroactively, if material, and, to enhance comparability between periods, financial statements presented for the periods affected should be restated for as many periods as is practicable to give retroactive effect to such adjustments and to changes in presentation. The division encourages earlier application of the recommendations in this statement for fiscal years beginning before December 25, 1978, in financial statements not previously issued.

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Section 10,250

Statement of Position 78-10 Accounting Principles and Reporting Practices for Certain Nonprofit Organizations

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Statement of Position 78-10 Accounting Principles and Reporting Practices for Certain Nonprofit Organizations

December 1978

[A Proposed Recommendation to the Financial Accounting Standards Board]

NOTE

Statements of position of the AICPA accounting standards division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the accounting standards executive committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, statements of position do not establish standards enforceable under the Institute's code of professional ethics.

INTRODUCTION

.001 The American Institute of Certified Public Accountants has issued the following industry audit guides applicable to certain types of nonprofit organizations.

- *Hospital Audit Guide* (1972)
- *Audits of Colleges and Universities* (1973)
- *Audits of Voluntary Health and Welfare Organizations* (1974)
- *Audits of State and Local Governmental Units* (1974)

.002 However, many nonprofit organizations are not covered by any of those guides. This statement of position is issued to recommend financial accounting principles and reporting practices for nonprofit organizations not covered by existing guides that prepare financial statements in conformity with generally accepted accounting principles. This statement is not intended to supersede or amend any of the listed guides. For numerous nonprofit organizations, complex accounting may be neither practical nor economical, and reporting based on cash receipts and disbursements or some other basis may be adequately informative. Under those circumstances, special-purpose financial reports should be prepared.

.003 The provisions of this statement need not be applied to immaterial items.

.004 A number of terms with specialized meanings are used throughout this statement and are defined in Appendix A.

.005 This statement of position applies to all nonprofit organizations not covered by the AICPA industry audit guides listed in paragraph .001, other than those types of entities that operate essentially as commercial businesses for the direct economic benefit of members or stockholders. Examples of the latter category are employee benefit and pension plans, mutual insurance companies, mutual banks, trusts, and farm cooperatives. Although this list is not all-inclusive, the following organizations are among those covered by this statement:

Cemetery organizations
Civic organizations
Fraternal organizations
Labor unions
Libraries
Museums
Other cultural institutions
Performing arts organizations
Political parties
Private and community foundations
Private elementary and secondary schools
Professional associations
Public broadcasting stations
Religious organizations
Research and scientific organizations

Social and country clubs
Trade associations
Zoological and botanical societies

.006 This statement of position applies to many diverse organizations. Some believe that separate accounting guidelines should be issued that fit the special requirements of each type of organization. Others, however, have criticized the published guides and this statement of position because of inconsistencies among the guides, contending that many of the inconsistencies cannot be justified. The accounting standards division believes that continuing to publish separate accounting papers or guidelines for different types of organizations would proliferate accounting practices unnecessarily. Similar transactions generally should be treated similarly by all organizations. The accounting standards division believes that it has considered the principal special requirements or conditions of the organizations covered by this statement of position and has provided special rules or exceptions where deemed appropriate.

.007 Some have contended that the division has not sufficiently considered the costs and efforts involved in implementing its recommendations—especially for smaller organizations. Some organizations may believe that special-purpose reports prepared on a basis other than generally accepted accounting principles better serve their needs—especially in light of the relationship between costs and benefits; these recommendations do not preclude such organizations from continuing to use appropriate special-purpose reports.

USERS OF FINANCIAL STATEMENTS

.008 A wide variety of persons and groups are interested in the financial statements of nonprofit organizations. Among the principal groups are (a) contributors to the organization, (b) beneficiaries of the organization, (c) the organization's trustees or directors, (d) employees of the organization, (e) governmental units, (f) the organization's creditors and potential creditors, and (g) constituent organizations.

.009 A principal purpose of a nonprofit organization's financial statements is to communicate the ways resources have been used to carry out the organization's objectives. It requires reporting the nature and amount of available resources, the uses made of the resources, and the net change in fund balances during the period. In addition, while adequate measures of program accomplishment generally are not available in the context of present financial statements, the financial statements should identify the organization's principal programs and their costs. A third aspect of financial reporting for nonprofit organizations is disclosure of the degree of control exercised by donors over use of resources. A fourth aspect is that the financial statements of a nonprofit organization should help the reader evaluate the organization's ability to carry out its fiscal objectives.

.010 The division has prepared this statement of position based on the foregoing concepts as a guide to preparing financial statements to be used primarily by persons outside the management of the organization. It recognizes that financial statements prepared for use by management or members of the governing board often require more detail than is prescribed in this statement.

ACCRUAL BASIS OF ACCOUNTING

.011 The accrual basis of accounting is widely accepted as providing a more appropriate record of all an entity's transactions over a given period of time than the cash basis of accounting. The cash basis or any basis of accounting other than the accrual basis does not result in a presentation of financial information in conformity with generally accepted accounting principles. Accordingly, financial statements of nonprofit organizations represented as being in conformity with generally accepted accounting principles should be prepared using the accrual basis of accounting.[1]

.012 For example, under accrual basis accounting, goods and services purchased should be recorded as assets or expenses at the time the liabilities arise, which is normally when title to the goods passes or when the services are received. Encumbrances representing outstanding purchase orders and other commitments for materials or services not yet received are not liabilities as of the reporting date and should not be reported as expenses nor included in liabilities on the balance sheet. However, significant commitments should be disclosed in the notes to the financial statements, and an organization may designate in its balance sheet the portion of the fund balance so committed.

[1] Some organizations keep their books on a cash basis throughout the period and, through adjustment at the end of the period, prepare statements on the accrual basis. The requirement is only that the financial statements be presented on the accrual basis and not that the books be kept on that basis throughout the period.

.013 For numerous nonprofit organizations, complex accounting procedures may be neither practical nor economical, and reporting based essentially on cash receipts and disbursements may be adequately informative. If financial statements prepared on the cash basis are not materially different from those prepared on the accrual basis, the independent auditor may still be able to conclude that the statements are presented in conformity with generally accepted accounting principles. Otherwise, cash basis financial statements should be considered to be special purpose financial statements and should be reported on accordingly.

FUND ACCOUNTING

.014 Many nonprofit organizations receive resources restricted for particular purposes. To facilitate observance of limitations, the accounts are often maintained using fund accounting, by which resources are classified for accounting and reporting purposes into funds associated with specified activities or objectives. Each fund is a separate accounting entity with a self-balancing set of accounts for recording assets, liabilities, fund balance, and changes in the fund balance. Although separate accounts are maintained for each fund, the usual practice in preparing financial statements is to group funds that have similar characteristics.

.015 The division believes that reporting on a fund accounting basis may be helpful where needed to segregate unrestricted from restricted resources. If an organization has restricted resources and elects not to report on a fund accounting basis, the financial statements should disclose all material restrictions and observe the specific requirements indicated in paragraphs .016 through .041, "Basic Financial Statements."

BASIC FINANCIAL STATEMENTS

.016 The basic financial statements, including related notes, of nonprofit organizations covered by this statement are—

- Balance sheet
- Statement of activity
- Statement of changes in financial position

.017 The balance sheet is intended to present financial position. The statement of activity, including changes in fund balances, is intended to present results of operations. However, when it is intended that the financial statements present both financial position and results of operations, all three statements listed in paragraph .016 should be presented.

.018 Although the division has identified the basic financial statements to be prepared, for the most part, it does not prescribe specific titles or formats. Each organization should develop the statement formats most appropriate to its needs in conformity with the principles discussed in this statement. A number of illustrative financial statements are presented in Appendix C to demonstrate the diversity of formats that can be used.

Balance Sheet

.019 The balance sheet should summarize the assets, liabilities, and fund balances of the organization.

.020 An organization's unrestricted fund balance represents the net amount of resources available without restriction for carrying out the organization's objectives. Those resources include amounts designated by the board for specific purposes, undesignated amounts, and, frequently, amounts invested in operating plant. While the balance sheet may set forth amounts designated for a program or other purposes, the total of all unrestricted fund balances, other than amounts shown in a plant fund, as discussed in paragraph .022, should be shown and labeled on the balance sheet.

.021 Current restricted resources and resources restricted for future acquisition of fixed assets should be reported in the balance sheet as deferred revenue until the restrictions are met. Other restricted resources such as endowment funds should be reflected separately in the fund balance section of the balance sheet. If significant, the nature of the restrictions on fund balances and deferred revenues should be described in the notes to the financial statments.

.022 Many organizations use a separate fund to account for the investments in operating plant, art collections, rare books and manuscripts, and similar items. The sources of the funds used to acquire those assets often are a combination of unrestricted and restricted funds. It may not be clear whether assets purchased with restricted funds continue to bear the original donor restrictions. While the division believes an organization should indicate whether the fund balances are restricted or unrestricted, that may not be possible for the plant fund. Thus, the plant fund may be reported separately or combined with either the unrestricted or restricted funds, as appropriate.

.023 Many organizations covered by this statement have only unrestricted funds. Those organizations should classify their assets as current, fixed, and other long-term assets and should classify their liabilities as current and long-term. To be classified as "current," the assets generally should be realizable and the liabilities payable within a normal operating cycle; however, if there is no normal operating cycle or the operating cycle is less than one year, all assets expected to be converted to cash or other liquid resources within one year and all liabilities to be liquidated within one year should be classified as current.

.024 Other organizations have both unrestricted and restricted funds. Frequently, the fund classifications themselves adequately disclose the current and long-term nature of the assets and liabilities. If not, a classified balance sheet should be presented.

Statement of Activity

.025 Throughout this statement of position the term *statement of activity* identifies the financial statement that reports the support, revenue, capital or nonexpendable additions, and functional expense categories. The statement might carry a different title, such as *statement of support, revenue, expense, capital additions, and changes in fund balances,* or simply *statement of changes in fund balances.* The statement of activity should include the activity for the period and a reconciliation between the beginning and ending fund balances. However, an organization may prepare two separate statements: a statement of activity and a statement of changes in fund balances. Changes in fund balances should include the excess or deficiency of revenue and support over expenses after capital additions for the period, adjustments to reflect changes in the carrying amount of certain marketable securities and other investments, as discussed in paragraph .080, and the additions and deductions of interfund transfers.

.026 The division has considered the diverse practices used to report details of financial activity. It has concluded that variations in format and presentation are appropriate, provided that the statement of activity shows the major sources and amounts of revenue and support, as well as the principal sources and amounts of additions to plant, endowment, and other capital funds. This does not prohibit an organization from reporting revenue and expenses separately from sources of support in its financial statements.

.027 Nonprofit organizations derive revenues from a variety of sources—dues, sale of services, ticket sales, investment income, and so forth—but they are often not sufficient to cover the cost of providing services. Many organizations, therefore, solicit support to enable them to fulfill their program objectives. Such support may be obtained from individuals, foundations, corporations, governmental units, and other entities.

.028 Certain contributions cannot be spent currently for program or supporting services because of donor or legal restrictions and have many of the characteristics of "capital." Such items include gifts, grants, and bequests to endowment, plant, and loan funds restricted either permanently or for a period of time by parties outside the organization. Those items also include investment income that has been restricted by donors and gains or losses on investments held in such funds that must be added to the principal.[2] The accounting standards division has concluded that disclosure of those items would be useful, and they should be differentiated from items that are available for current operations. Captions such as "capital additions," or "nonexpendable additions," should be used.

.029 Capital additions do not include restricted gifts, grants, bequests, or gains on the sale of assets that can be used for current activities even though the contributions have been deferred until the organization incurs an expense that satisfies the terms of the restriction, nor do they include unrestricted amounts that the board designates as nonexpendable. See paragraphs .054 through .062 for a further discussion on current restricted gifts, grants, bequests, and other income.

.030 While there is wide diversity of practice, the division concluded that an "excess" line-item caption in the statement of activity is useful. Although the purpose of the organizations covered by this statement is not to make "profits" as this term is generally used, nonprofit entities can survive only if they have support, revenue, and other additions equal to or in excess

[2] The division does not suggest that gains on the sales of restricted assets are legally restricted or that they cannot be used at the discretion of the organization. Those are legal questions that depend on applicable law, donor intent, or both.

of expenses. This measure is an important indicator of financial health and is therefore of interest to management, members of the governing board, donors, beneficiaries, and other users of the financial statements. Accordingly, the statement of activity should report the excess (deficiency) of revenues and support over expenses for the period.

.031 If financial activities include capital additions, there should be *two* clearly labeled "excess" line-item captions, such as "excess (deficiency) of revenue and support over expenses before capital additions" and "excess (deficiency) of revenue and support over expenses after capital additions" (alternative wording may be used).

Statement of Changes in Financial Position

.032 The statement of changes in financial position provides a summary of available resources and their use during the period.

.033 Many nonprofit organizations obtain their resources from contributions, borrowed money, investment income, and so forth. The statement of changes in financial position provides the user with information about both the methods of financing programs and activities and the use and investment of resources during the period.

.034 The statement of changes in financial position should summarize all changes in financial position, including capital additions, changes in deferred support and revenue, and financing and investing activities.

Other Types of Fund Classifications

.035 Rather than using the traditional fund accounting classifications, some organizations prefer using classifications such as expendable and nonexpendable or unrestricted and restricted in their financial statements. Such classifications are appropriate provided that all the required disclosures indicated in paragraphs .016 through .041 are met.

Columnar v. Layered Presentation

.036 The practice of presenting data by major fund groups has evolved to emphasize meaningful distinctions between the types of unrestricted and restricted resources for which an organization is accountable. Many organizations report financial position and results of activities in a multicolumn format. Others report their financial statements in a layered or "pancake" format, and still others report certain data in a columnar format and other data in a layered format. Each organization should develop the statement format most appropriate to its needs to conform with the principles discussed in this statement of position.

Totals of All Funds

.037 Some organizations present their financial statements (either in columnar or layered format) only by major fund groups without showing totals of all funds. They do not consider totals of all funds to be meaningful and sometimes consider such totals to be misleading because of restrictions on the use of certain resources; however, other organizations, believing that totals are meaningful, present details by major fund groups and totals of all funds in one or more of their statements.

.038 Certain organizations present financial statements showing only the totals of all funds and do not show the major fund groups. Organizations do that if they do not establish separate funds for reporting purposes, if the financial information concerning particular funds is not significant, or if such information can be adequately set forth in other ways in the statements or the notes.

.039 Financial statements in columnar format lend themselves to presenting totals of all funds. Financial statements presented in layered format lend themselves to fund group presentations with comparative data for the preceding period.

.040 The presentation of totals of all fund groups in all financial statements is preferable, although not required. In presenting such totals, the specifics of the major fund groups should also be provided, and care should be taken to assure that the captions are not misleading and that adequate information is provided concerning interfund borrowings and important restrictions on the uses of resources.

Comparative Financial Statements

.041 Although it is not required, financial statements of the current period should be presented on a comparative basis with financial statements for one or more prior reporting periods. If multi-column financial statements are presented for the current period, some organizations prefer to present only summarized, total-all-funds information (in a single column) for each of the prior periods because of space limitations and to avoid the confusion that a second set of multi-column statements might cause. However, where it is intended to present financial statements of the prior periods as well as the current period in accordance with generally accepted accounting principles, care must be taken that there is sufficient disclosure in the summarized data and in the supporting notes.

FINANCIALLY INTERRELATED ORGANIZATIONS

.042 For a reporting organization that controls another organization having a compatible purpose, it is presumed that combined or combining financial statements are more meaningful than separate statements and are usually necessary for a fair presentation in conformity with generally accepted accounting principles. *Control* means the direct or indirect ability to determine the direction of the management and policies through ownership, by contract, or otherwise.

.043 The accounting standards division has considered the foregoing definition in relation to the nonprofit organizations covered by this statement of position and has concluded that it may be construed by some to be so broad, considering the structure of some nonprofit organizations, that presentation of combined financial statements might have relatively little value to users of such combined statements, particularly in relation to the cost of their preparation.

.044 Nevertheless, the division has concluded that combined financial statements are necessary for informative presentation of certain financially interrelated organizations. To balance these objectives, combined financial statements should be presented if (1) control exists as defined in paragraph .042 and (2) any of the following circumstances exists:

a. Separate entities solicit funds in the name of and with the expressed or implicit approval of the reporting organization, and substantially all of the funds solicited are intended by the contributor or are otherwise required to be transferred to the reporting organization or used at its discretion or direction.

b. A reporting organization transfers some of its resources to another separate entity whose resources are held for the benefit of the reporting organization.

c. A reporting organization assigns functions to a controlled entity whose funding is primarily derived from sources other than public contributions.

The basis for combining financial statements, including the interrelationship of the combined organizations, should be disclosed in the notes to the financial statements.

.045 Legally unrestricted resources held by organizations related to the reporting organization may be effectively restricted with respect to the reporting organization. In combined financial statements that include both the related organization and the reporting organization, it may be appropriate to present all resources of the related organization, both unrestricted and restricted, as restricted resources.

.046 A national or international organization may have state or local chapters with varying degrees of autonomy. Affiliated organizations may be separate corporate entities or unincorporated boards, committees, or chapters. It is not intended to require a national or "parent" organization with loosely affiliated local organizations whose resources are principally derived and expended locally to combine the local organizations' financial statements with its own. The loose affiliation of the local organization would be characterized by locally determined program activities, financial independence of the local organization, and local organization control of its assets. Therefore, combined financial statements need not be presented unless the financial relationships between the entities are as described in paragraph .044.

.047 If affiliated organizations are not combined because they do not meet the combining criteria or have loosely affiliated local organizations, the existence of the affiliates and their relationships to the reporting organization should be disclosed.

.048 In view of the unique and complex organizational relationships and degrees of local autonomy common in religious organizations, there may be many circumstances in which application of this section on combination would not result in meaningful financial information. Thus, if a religious organization concludes that meaningful financial information would not result from the presentation of combined financial statements, the provisions of this section need not be applied.

Related-Party Transactions

.049 Contributions made to an organization by its governing board members, officers, or employees need not be separately disclosed if the contributors receive no reciprocal economic benefits.

REVENUE, SUPPORT, AND CAPITAL ADDITIONS

.050 The statement of activity should report revenue, support, and capital additions. Revenue and support are discussed under "Statement of Activity," paragraphs .025 through .031.

Capital Additions

.051 Capital additions include nonexpendable gifts, grants, and bequests restricted by donors to endowment, plant, or loan funds either permanently or for extended periods of time. Capital additions also include legally restricted investment income and gains or losses on investments held in such funds that must be added to the principal.[3] Capital additions do not include donor-restricted gifts for program or supporting services.

.052 Capital additions that are restricted for acquisition of plant assets should be treated as deferred capital support in the balance sheet until they are used for the indicated purpose. Once used, these amounts should be reported as capital additions in the statement of activity.

.053 Some organizations may prefer to use the caption "nonexpendable additions" instead of "capital additions." As previously noted, that or other wording is acceptable.

Current Restricted Gifts, Grants, Bequests, and Other Income

.054 Current restricted gifts, grants, bequests, and other income provide expendable resources that have been restricted by donors, grantors, or other outside parties to the purposes for which they may be used. Such restrictions usually involve written assertions expressed in restrictive language by one party to the other. Amounts received from appeals for restricted funds by solicitation letter, radio, television, newspaper, and so forth are generally deemed to be restricted according to the nature of the appeal.

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[3] See footnote 2.

.055 Two alternative accounting conventions have been used for reporting current restricted resources. Some report the full amount of such resources when received as "revenue and support" in a current restricted fund column in the statement of activity, without regard to whether the resources were used or the restrictions met.[4] Unspent amounts are reported in the "excess (deficiency) of revenue and support over expenses" and included in the fund balance of the current restricted fund.

.056 This accounting convention is used because restricted resources are available for current use regardless of whether they are spent, and full accountability requires that this be recognized by reflecting receipt of such resources as revenue and support. Those who disagree express concern that the recognition of such amounts as revenue and support overlooks the legal obligation to return the resources if they are not used for the restricted purpose. They further contend that large amounts received near the end of the period may significantly distort the financial statements of the organization.

.057 The other accounting convention has been based on an assumption that a donee organization should not recognize such amounts as revenue until the particular resources are used for the purpose specified by the donors, since they are not "earned" until they are used and the restrictions met.[5] Under this accounting convention, receipts of current restricted funds are not reported as revenue until the resources are expended for the purpose specified. Until then, they are reported as a direct addition to the fund balance of the current restricted fund.

.058 This approach may be satisfactory for restricted grants that impose conditions of discrete accountability with the requirement that unspent balances be refunded to the grantors. However, it allows management to defer recognition of restricted support as revenues although applicable expenses have been incurred.

.059 The accounting standards division believes that neither accounting convention is entirely satisfactory and that the conventions should be changed based on the following concepts:

a. The recognition of the receipt of restricted funds as revenues should be determined by economic events rather than by

[4] This is the approach recommended by the AICPA industry audit guide, *Audits of Voluntary Health and Welfare Organizations* (New York: AICPA, 1974).

[5] This is the approach recommended by the AICPA industry audit guides for hospitals and for colleges and universities.

arbitrary management decisions. The same economic events affecting two similar organizations in a similar manner should not appear to produce two different results because of differences in the management objectives.

b. For accounting purposes, donor restrictions are complied with when the organization incurs an expense for the function, program, project, or object and in the manner specified in the donative instrument or grant award unless such expense is attributable to other restricted funds.

c. Unexpended restricted funds should be reported in a manner that reflects the restrictions attached to such funds.

.060 For example, if a donor restricted a contribution or responded to an appeal for restricted contributions to be used for a specific program service and the organization subsequently, or in anticipation of receiving the restricted contributions, incurred expenses for that particular program service, the accounting standards division believes the obligation imposed by the restriction should be deemed to have been met even if unrestricted funds were used. Management should not avoid recognizing the restricted contribution as support in that period simply because it chose to use dollars attributed to unrestricted funds at the time the expense was incurred.

.061 Unless the donor specifies to the contrary, the donee organization should consider only expenses incurred after the receipt of the restricted contribution as meeting the restriction. This does not apply if the donor or grantor contributes in response to an appeal that specifies that the related expenses may have already been incurred in whole or in part.

.062 The division has concluded, therefore, that current restricted gifts, grants, bequests, and other income should be accounted for as revenue and support in the statement of activity to the extent that expenses have been incurred for the purpose specified by the donor or grantor during the period. The balances should be accounted for as deferred revenue or support in the balance sheet outside the fund balance section until the restrictions are met. The specific language in the donative instrument or grant award should govern whether restrictions have been met. Recognition of expenses that satisfy donor restrictions results in recognition of equivalent amounts of revenue or support in that period.

Unrestricted Gifts, Grants, and Bequests

.063 Unrestricted gifts, grants, and bequests should be reported in the unrestricted fund in the statement of activity above the caption "excess (deficiency) of revenue and support over expenses before capital additions."

Pledges

.064 Pledges an organization can legally enforce should be recorded as assets and reported at their estimated realizable values. In determining these values, such matters as the donee organization's past collection experience, the credit standing of the donor, and other matters affecting the collectibility of the pledges should be considered.

.065 The estimated realizable amount of pledges should be recognized as support in the period designated by the donor. If the period designated by the donor extends beyond the balance sheet date, the pledge should be accounted for as deferred support in the balance sheet. In the absence of a specified support period, the net estimated realizable amount of pledges scheduled to be received over a future period should be assumed to be support for that period and should be accounted for as deferred support in the balance sheet.

.066 Pledges for fixed assets should also be recorded in the balance sheet at their estimated realizable values and reported in the statement of activity as provided in paragraph .052.

Donated and Contributed Services

.067 The nature and extent of donated or contributed services received by organizations vary and range from the limited participation of many individuals in fund-raising activities to active participation in the organization's service program. Because it is difficult to place a monetary value on such services, their values are usually not recorded. The accounting standards division believes that those services should not be recorded as an expense, with an equivalent amount recorded as contributions or support, unless all of the following circumstances exist:

a. The services performed are significant and form an integral part of the efforts of the organization as it is presently constituted; the services would be performed by salaried personnel if donated or contributed services were not available for the organization to accomplish its purpose; and the organization would continue this program or activity.

b. The organization controls the employment and duties of the service donors. The organization is able to influence their activities in a way comparable to the control it would exercise over employees with similar responsibilities. This includes control over time, location, nature, and performance of donated or contributed services.

c. The organization has a clearly measurable basis for the amount to be recorded.

d. The services of the reporting organization are not principally intended for the benefit of its members. Accordingly, donated and contributed services would not normally be recorded by organizations such as religious communities, professional and trade associations, labor unions, political parties, fraternal organizations, and social and country clubs.

.068 Participation of volunteers in philanthropic activities generally does not meet the foregoing criteria because there is no effective employer-employee relationship. (See criterion *b*, above.)

.069 Services that generally are not recorded as contributions, even though the services may constitute a significant factor in the operation of the organization, include the following:

a. Supplementary efforts of volunteer workers that are provided directly to beneficiaries of the organization. Such activities usually involve auxiliary activities or other services that would not otherwise be provided by the organization as a part of its operating program.

b. Periodic services of volunteers in concentrated fund-raising drives. The activities of volunteer solicitors are not usually subject to a degree of operating supervision and control by the organization sufficient to provide a basis for measuring and recording the value of time devoted. However, if individuals perform administrative functions in positions that would otherwise be held by salaried personnel, consideration should be given to recording the value of those services.

.070 Notes to the financial statements should disclose the methods used by the organization in valuing, recording, and reporting donated or contributed services and should distinguish between donated or contributed services for which values have and have not been recorded.

Donated Materials and Facilities

.071 Donated material and facilities, if significant in amount, should be recorded at their fair value, provided the organization has a clearly measurable and objective basis for determining the value. If the materials are such that values cannot reasonably be determined, such as clothing, furniture, and so forth, which vary greatly in value depending on condition and style, they should not be recorded as contributions. If donated materials pass through the organization to its charitable beneficiaries, and the organization serves only as an agent for the donors, the donation should not be recorded as a contribution. The recorded value of the use of contributed facilities should be included as revenue and expense during the period of use.

Investment Income and Gains and Losses

.072 Unrestricted investment income (interest and dividends) from all funds should be reported as revenue in the statement of activity when it is earned. All unrestricted gains and losses on investments of unrestricted and current restricted funds should also be reported in the statement of activity before the excess (deficiency) of revenue and support over expenses before capital additions. See paragraphs .077 through .082 for a discussion of the carrying amount of investments and the bases of reporting gains and losses.

.073 As discussed in paragraph .021, restricted investment income and restricted gains and losses from investments of current restricted funds and restricted plant funds should be reported as deferred amounts in the balance sheet. Restricted expendable income from investments of endowment funds should also be reported as deferred amounts. Income from investments of endowment funds that must be added to the principal by direction of the donor should be reported as capital additions. Gains and losses on investments of endowment funds should be reported as capital additions or deductions.

.074 Traditionally, nonprofit organizations have accounted for income yield (dividends, interest, rents, royalties, and so forth) as revenues available for current purposes and have excluded from that category capital gains on investment transactions of the endowment fund.

.075 In recent years, some institutions have adopted what is usually referred to as a "total return" approach to the management of investments of endowment and quasi-endowment funds. This investment approach emphasizes total investment return consisting of traditional yield plus or minus gains and losses. Typically, the governing board establishes a "spending rate" that is satisfied by traditional yield first, that is, by dividends and interest. To the extent that traditional yield is inadequate to meet the spending rate, the governing board may make a portion of realized, and in some cases unrealized, net gains available for current use. The use of net gains on investments of true endowment funds by the governing board is usually done with the advice of legal counsel.

.076 A problem arises in the method of accounting for the available net gains from endowment funds because the concept thus far has produced few, if any, applications that appear to be objectively determinable. For example, some institutions have reported net gains made available as revenues, while most others follow existing AICPA industry audit guides and account for this transaction as a transfer from endowment funds to other funds. In some situations when traditional yield has exceeded the spending rate, the excess has been added directly to endowment fund balances rather than being reported as revenue. The spending rate policies of many institutions tend to place primary emphasis on spending without regard to the effect on endowment fund principal. While all of the total return approaches emphasize the use of prudence and a rational and systematic formula, those matters are subjective and not susceptible to measurement. Consequently, the accounting standards division concludes that the portion of available net gains from endowment investments utilized should be reported in the statement of activity as a transfer from endowment funds to other funds. To the extent such gains are transferred to a restricted fund in which unexpended gifts and investment income are reported as deferred support and revenues, the gains should be transferred to deferred revenue of that fund. Since quasi-endowment funds are to be accounted for as a part of current funds, using net gains on the investments of these funds does not involve a transfer. Such gains and losses should be accounted for in the manner specified in paragraph .072.

Carrying Amount of Investments

.077 Nonprofit organizations have traditionally carried purchased investments at cost and donated investments at fair value at date of receipt. Investments have normally been written down to market value when market values have declined below the carrying value and the declines were deemed to be permanent impairments. Beginning in 1973 with the issuance of the AICPA industry audit guide for colleges and universities, some nonprofit organizations have been carrying their investments at market, as a permissible alternative to cost, adjusting the carrying amount each year for value increases and decreases.

.078 An organization carrying investments at market value recognizes the gains or losses that result from market fluctuations for the period in which the fluctuations occur. Those who are against carrying investments at market are concerned both with the difficulty of valuing nonmarketable investments and the effect that market fluctuations have on an organization's results of activity as reflected in the financial statements.

.079 The division has concluded that organizations covered by this statement of position should report investments in the financial statements as follows:

- Marketable debt securities, when there is both the ability and intention to hold the securities to maturity, should be reported at amortized cost, market value, or the lower of amortized cost or market value;
- Marketable equity securities and marketable debt securities that are not expected to be held to maturity should be reported at either market value or the lower of cost or market value;
- Other types of investments, for example, real estate or oil and gas interests, should be reported at either fair value or the lower of cost or fair value.

The basis selected to value each of these three groups of investments should apply to all investments in that group. When investments are carried at other than market value, disclosure of market value for that group at the balance sheet date should be made.

.080 For investments carried at the lower of (amortized) cost or market value, the division believes that declines should be recognized when the aggregate market value by fund group is less than the carrying amount. Recoveries of aggregate market amount in subsequent periods should be recorded in those periods subject only to the limitation that the carrying amount should not exceed the original cost. The adjustments to recognize the increases or decreases resulting from the application of this paragraph for noncurrent investments should be recognized as a direct addition or deduction to the fund balance; the adjustments applicable to current investments should be reflected in the statement of activity in the same manner as realized gains and losses. Investments held in current restricted funds should normally be considered to be current investments for purposes of this paragraph.

.081 For investments carried at market value, increases or decreases in market value should be recognized in the period in which they occur, as described in paragraphs .072 and .073.

.082 Interfund sales or exchanges of investments that involve a restricted fund should be recorded in the purchasing fund at fair value. The difference between the carrying amount and the fair value at the date of the sale or exchange should be accounted for in the selling fund in the same manner as realized gains and losses and appropriately disclosed.

.083 The notes to the financial statements should set forth a summary of the total realized and unrealized gains and losses and income derived during the fiscal period from investments held by all funds except life income and custodial funds.

Subscription and Membership Income

.084 Subscriptions and revenues derived from the performance of services or the sale of goods should be recognized as revenue in the periods in which they are provided. Revenue derived from membership dues should be recognized by the organization over the period to which the dues relate. Nonrefundable initiation and life membership fees should be recognized as revenue in the period the fees are receivable, if future dues or fees can reasonably be expected to cover the cost of future services; otherwise, the fees should be amortized to future periods based on average membership duration, life expectancy, or other appropriate methods. However, if items such as dues, assessments, and nonrefundable initiation fees are in substance contributions and services are not to be provided to the member, they should be recognized as revenue and support in the periods in which the organization is entitled to them.

EXPENSES

Functional Classification of Expenses

.085 Organizations that receive significant support in the form of contributions from the general public should summarize the cost of providing various services or other activities on a functional basis in the statement of activity. (For purposes of this paragraph, the accounting standards division believes that organizations receiving support from federated fund-raising or similar organizations are deemed to have received support from the general public.) Organizations receiving no significant support from such contributors are encouraged to report on a functional basis but may choose to summarize expenses on another basis (such as natural classifications) that would be considered useful to readers of the statement of activity. If expenses are not reported on a functional basis, the notes should contain a description of the basic programs of the organization. The remainder of this section is for those organizations that report expenses on a functional basis.

.086 The functional classifications should include specific program services that describe the organization's service activities and supporting services, such as management and general and fund-raising.

.087 The statement of activity should present costs separately for each significant program and supporting activity. Program activities are those directly related to the purposes for which the organization exists. Supporting activities do not relate directly to the purposes for which the organization exists. Fund raising, membership development, and unallocated management and general expense are three examples of supporting activities that should be reported separately.

.088 An organization may also present as supplementary information a schedule of functional expenses by object classification, that is, classifying expenses by type rather than function, such as salaries, employee-benefit expenses, and purchased services.

Program Services

.089 Functional reporting classifications for program services vary according to the nature of the service rendered. For some organizations, a single functional reporting classification may be adequate to portray the program service provided. In most cases, however, several separate and identifiable services are provided, and in such cases, expenses for program services should be reported by the type of service function or group of functions. The purposes of the various functions should be clearly described, and each functional classification should include all of the applicable service costs.

.090 Some local organizations remit a portion of their receipts to an affiliated state or national organization. The amount to be paid to the affiliates should be reported as either an expense or a deduction from total support and revenue in the statement of activity. The appropriate treatment depends on the arrangements: A reporting organization that is, in effect, a collecting agent for the state or national organization, such as local organizations that are required to remit a fixed percentage of all contributions, should report the remittance as a deduction from total support and revenue; other organizations should report the remittance as a program expense.

Management and General Costs

.091 Management and general costs are those not identifiable with a single program or fund-raising activity but are indispensable to the conduct of those activities and to an organization's existence, including expenses for the overall direction of the organization's general board activities, business management, general recordkeeping, budgeting, and related purposes. Costs of overall direction usually include the salary and expenses of the chief officer of the organization and his staff. However, if such staff spend a portion of their time directly supervising program services or categories of supporting services, their salaries and expenses should be prorated among those functions. The costs of disseminating information to inform the public of the organization's "stewardship" of contributed funds, announcements concerning appointments, the annual report, and so forth, should likewise be classified as management and general expenses.

Fund-Raising and Other Supporting Services

.092 Fund-raising costs are incurred in inducing others to contribute money, securities, time, materials, or facilities for which the contributor will receive no direct economic benefit. They normally include the costs of personnel, occupancy, maintaining mailing lists, printing, mailing, and all direct and indirect costs of soliciting, as well as the cost of unsolicited merchandise sent to encourage contributions. The cost of such merchandise should be disclosed. Fund-raising costs paid directly by a contributor should be reported as support and as fund-raising expenses.

.093 Some organizations hold special fund-raising events, such as banquets, dinners, theater parties, and so forth, in which the donor receives a direct benefit (for example, a meal or theater ticket). Some organizations sell merchandise as a fund-raising technique. The costs of such merchandise or direct benefits are not considered fund-raising costs and should be applied against gross proceeds received from the person receiving such direct benefit. The costs of such merchandise or direct benefit costs should be disclosed.

.094 A growing number of users of financial statements are seeking financial information that will enable them to evaluate fund-raising costs. A single functional reporting classification ordinarily is adequate to portray the fund-raising activity; however, other organizations may believe that reporting total public support and total fund-raising expense does not provide adequate information for a useful evaluation because the organizations conduct a number of fund-raising activities with widely varying relationships. For those organizations, it may be appropriate to report fund-raising costs and the corresponding support obtained separately for each type of fund-raising function, either in the statement of activity or in the notes. The various fund-raising functions should be adequately described and should include all of the applicable costs. The total of all fund-raising activities should be disclosed whether the entity reports expenses on a functional or some other basis.

.095 Fund-raising efforts made in one year, such as those made to obtain bequests or to compile a mailing list of prospective contributors, often result in contributions that will be received in future years. Some have advocated deferring the costs of such fund-raising efforts until the period in which the contributions are expected to be received. Although there may be valid reasons to consider deferring those costs, the accounting standards division is concerned with the difficulty of assessing their ultimate recovery and the possibility of misstating the fund-raising cost relationships. Accordingly, fund-raising costs should be expensed when incurred. However, if pledges or restricted contributions that have already been received are recorded as deferred revenue and support, related fund-raising costs, if specifically identifiable with the contributions, may also be deferred if it is clear that the contributor intended that the contribution could be used to cover such costs. Similarly, costs incurred in the acquisition of literature, materials, and so forth, that will be used in connection with a fund-raising drive to be conducted in a succeeding period should be deferred to that period.

.096 Costs incurred in the solicitation of grants from foundations or governments and cost of membership development in bona fide membership organizations should be shown as separate categories of supporting expenses. If the membership fee includes an element of contribution, the costs of membership development should be allocated between membership development and fund raising.

.097 If an organization combines the fund-raising function with a program function (for example, a piece of educational literature with a request for funds), the costs should be allocated to the program and fund-raising categories on the basis of the use made of the literature, as determined from its content, the reasons for its distribution, and the audience to whom it is addressed.

Allocation of Costs That Pertain to Various Functions

.098 In some larger organizations, individual functions are performed by separate departments, with expenses classified by types within each department. Many other organizations incur items of cost that apply to more than one functional purpose. For those organizations, it may be necessary to allocate the costs among functions. Examples include salaries of persons who perform more than one type of service, rental of a building used for various program services, management and general expenses, and expenses of fund-raising activities.

.099 The salaries of employees who perform duties relating to more than one function, as well as all other expenses pertaining to more than one function, should be allocated to the separate functional categories according to procedures that determine, as accurately as possible, the portion of the cost related to each function.

.100 A reasonable allocation of an organization's functional expenses may be made on a variety of bases, and costs that have been allocated to programs and supporting services should be disclosed in the notes to the financial statements. It is not the intention of this statement to require organizations to undertake extensive detailed analyses and computations aimed at making overly meticulous allocations. The division recognizes that meaningful financial statements can often be prepared using estimates and overall computations when appropriate. (See Appendix B for illustrative allocation procedures.)

Grants

.101 Organizations that make grants to others should record grants as expenses and liabilities at the time recipients are entitled to them. That normally occurs when the board approves a specific grant or when the grantee is notified.

.102 Some grants stipulate that payments are to be made over a period of several years. Grants payable in future periods subject only to routine performance requirements by the grantee and not requiring subsequent review and approval for continuance of payment should be recorded as expenses and liabilities when the grants are first made. However, if the grant instrument specifically states that the grantor reserves the right to revoke the grant regardless of the performance of the grantee, unpaid grants should not be recorded. Grants subject to periodic renewal should be recorded as expenses and liabilities at renewal with a disclosure of the remaining commitment in the notes to the financial statements.

Tax Allocation

.103 Certain organizations are subject to a federal excise tax on investment income or to federal and state income taxes on certain unrelated business income. If timing differences exist between the income base for tax and financial reporting purposes, interperiod allocation of tax should be made.

Transfers

.104 Allocations of resources among fund groups are neither revenues nor expenses of the related funds and should be distinguished from support and revenues that increase the total resources available to fulfill the objectives of an organization. Therefore, interfund transfers, including board-designated transfers of gains under the total-return concept, should be reported as changes in fund balances under the caption "fund balance beginning of the period." Transfers required under contractual arrangements with third parties should be separately disclosed. Transfers required as a result of the expiration of a term endowment fund also should be separately disclosed.

BALANCE SHEET

Fixed Assets

.105 Nonprofit organizations should capitalize purchased fixed assets at cost. Donated fixed assets should be recorded at their fair value at the date of the gift. Organizations that have not previously capitalized their fixed assets should do so retroactively. If historical costs are unavailable for assets already in service, another reasonable basis may be used to value the assets. Other bases might be cost-based appraisals, insurance appraisals, replacement costs, or property tax appraisals adjusted for market. However, an alternative basis should be used only if historical cost information is unavailable and only to establish a value at the date an organization adopts this statement of position. Subsequent additions should be recorded at cost, or fair value for donated assets. The basis of valuation and the amount of any assets pledged to secure outside borrowing should be disclosed in the financial statements.

Depreciation

.106 In Accounting Terminology Bulletin no. 1, *Review and Résumé,* the AICPA Committee on Terminology, defined *depreciation accounting* as a means of allocating the cost or other carrying value of tangible capital assets to expense over their useful lives:

> *Depreciation accounting* is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not valuation. *Depreciation for the year* is the portion of the total charge under such a system that is allocated to the year. Although the allocation may properly take into account occurrences during the year, it is not intended to be a measurement of the effect of all such occurrences.

.107 Exhaustible fixed assets should be depreciated over their estimated useful lives. The relative effort being expended by one organization compared with others and the allocation of the efforts to various programs of the organization are indicated, in part, by cost determinations. Depreciation of fixed assets used in providing such services is relevant as an element of that cost. Although depreciation can be distinguished from most other elements of cost in that it requires no current equivalent cash outlay, recognition of depreciation as a cost is not optional. Most assets used in providing services are both valuable and exhaustible. Thus, a cost is associated with the use of exhaustible assets whether they are owned or rented, acquired by gift or by purchase or used by a business or a nonprofit organization.

.108 Assets that are not exhaustible, such as landmarks, monuments, cathedrals, or historical treasures, need not be depreciated. Structures used primarily as houses of worship need not be depreciated.

.109 An organization may receive grants, allocations, or reimbursements from other organizations on the basis of the cost associated with its program and supporting services. Recording depreciation as an element of cost does not indicate that it necessarily should be included in the base on which grants, allocations, or reimbursements will be determined: whether the base includes or excludes depreciation depends on the agreement or understanding reached between the two organizations.

.110 The amount of depreciation provided on assets carried at historical cost and the amount, if any, provided on assets carried on a basis other than historical cost should be disclosed.

.111 Depreciation accounting is sometimes confused with funding replacements. The means of replacing fixed assets and the degree to which replacements should be funded currently are financing decisions to be made by the governing board and do not directly affect the current costs of providing program or supporting services. Depreciation accounting is designed to determine and present those costs, not to provide replacement funds.

.112 Retroactive adjustments should be made to reflect accumulated depreciation as of the date an organization adopts this statement of position. For this purpose, the determination of asset lives should be based on a combination of the period from acquisition to the adoption date, plus estimated remaining life based on the current condition and planned use of the assets. When an organization records fixed assets using one of the "current value" methods referred to in paragraph .105, it is not necessary to disclose accumulated depreciation that would have been recorded had cost-based data been available.

Collections

.113 The accounting standards division considered at length the desirability of capitalizing (but not depreciating) the inexhaustible collections owned by museums, art galleries, botanical gardens, libraries, and similar entities. In view of the stewardship of those organizations to the public, it is desirable to catalogue and control the collections. Some believe that it is also desirable to present values for the collections on the organizations' balance sheets, since those values usually represent the largest assets of the organizations. The division has concluded that it is often impracticable to determine a value for such collections and accordingly has concluded that they need not be capitalized. If records and values do exist for the collections, the division encourages capitalization, at cost, if purchased, and at a fair value, if acquired by donation. If historical cost is indeterminable, the alternative methods of valuing described in the section on fixed assets should be used. If such collections are not capitalized, the caption "collections" should appear on the balance sheet with no amount shown but with a reference to a note that describes the collections.

.114 The nature and the cost or contributed value of current-period accessions and the nature of and proceeds from deaccessions should be disclosed in the financial statements.

.115 Collections that are exhaustible, such as exhibits with a limited display life, and that have been capitalized should be amortized over their useful lives.

Investment Pools

.116 To obtain investment flexibility, nonprofit organizations frequently pool investments of various funds. Inasmuch as the realized and unrealized gains or losses and income of specific investments cannot be identified with the specific funds participating in the pool, realized and unrealized gains or losses and income should be allocated equitably. To accomplish an equitable allocation, investment pools should be operated using the "market value unit method." Under that method, each fund is assigned a number of units based on the relationship of the market value of all investments at the time of entry in the pool. Periodically, the pooled assets are valued and new unit values are calculated. The new unit value is used to determine the number of units to be allocated to new funds entering the pool or to calculate the equity of funds withdrawing from the pool. Investment pool income, gains, and losses should be allocated periodically to participating funds based on the number of units held by each fund during the period. Other methods based on market value, including percentage participation, may also accomplish the same result.

.117 Pooled investments may include investments carried at other than market value even though, as indicated in paragraph .116, the pool itself must be operated on the basis of market value. Differences may exist between the carrying amounts of assets and fund balances withdrawn from the investment pool. Such differences should be allocated to the participating funds remaining in the pool in the same manner as income, gains, and losses. Alternatively, such adjustments could be reported separately from the carrying amount of specific investments or the fund balances of funds remaining in the pool.

Interfund Borrowings

.118 A governing board may sometimes authorize borrowings from restricted, endowment, or plant funds. The organization should determine if interest should be accrued. Interfund borrowings should be considered permanent and recorded as transfers when it becomes evident that contemplated sources of funds for repayment are not readily available. There may be legal prohibitions against lending such funds and against recording such transfers. If so, appropriate disclosure should be made.

.119 Material interfund borrowings should be disclosed when restricted funds have been loaned or when the liquidity of either fund is in question. If summary financial information is presented for a prior period, similar disclosure should be made.

Designations of Fund Balances

.120 The governing board of an organization may designate a portion of an unrestricted fund balance for a specific purpose. The designation is proper to the board's managerial function. However, such designations of fund balances are not expenses and should not be shown as such in the statement of activity. (See examples of designations in the Illustrative Financial Statements, Appendix C.)

Other Funds

.121 Donors frequently make gifts of future interests. The present value of the actuarially determined liability resulting from an annuity gift should be recorded at the date of the gift. The excess (or deficiency) in the amount of the annuity gift over the liability should be recorded as support in the year of the gift if it may be used immediately for the general purposes of the organization; in other instances, the excess should be reported as deferred revenue if restricted for specific purposes.

The principal amount of life income gifts, in which the donor reserves the right to the income generated from the gift for life or some other stipulated period of time, should also be recorded as deferred support in the balance sheet in the period the gift is received. The amount previously recorded as deferred support should be reflected as support or a capital addition at the future date when the terms of the annuity or life income gifts have been met.

.122 Funds that are held in trust by others under a legal trust instrument created by a donor independently of the reporting organization and that are neither in the possession nor under the control of the organization but are held and administered by outside fiscal agents with the organization deriving income from such funds should not be included in the balance sheet with funds administered by the organization. The funds contemplated by this paragraph are those of which the reporting organization is not the remainderman in the trust. Their existence should be disclosed either parenthetically in the endowment funds group in the balance sheet or in the notes to the financial statements. Significant income from such trusts should be reported separately.

.123 Certain organizations have customarily used other fund groups not specifically mentioned in this statement. Those fund groups are used to account for resources relating to activities such as agency or custodial relationships, self-administered pensions, and permanent maintenance funds. Such fund groups are frequently useful and informative and, therefore, may be reported separately in the financial statements. Alternatively, those funds may be combined with other similar fund groups to simplify statement presentation. In either case, the accountability for the fund group should be classified according to the exact nature of the funds involved, so that balances that are liabilities (such as agency, custodial, and self-administered pension funds) are distinguished from those that are fund balances (such as permanent maintenance funds). If there are true fund balances, changes in the balances should be accounted for in the statement of activity. The restricted nature of such funds should also be disclosed.

TRANSITION

.124 The accounting standards division recognizes that the Financial Accounting Standards Board presently has on its agenda a project on "Objectives of Financial Reporting by Nonbusiness Organizations." The results of that project may affect financial reporting by the entities covered by this statement of position. On completion of that project, any recommendations in this statement of position that conflict with the FASB's conclusions would need to be changed. Accordingly, the division has concluded that the principles contained in this statement of position need not be adopted until after the Financial Accounting Standards Board completes its project. At that time, a specific date on which the adoption of these principles is recommended will be announced. Organizations may voluntarily adopt these principles.

.125 Organizations that adopt the conclusions of this statement of position should apply them retroactively by prior-period adjustments. If financial statements for periods prior to adoption are not presented, the conclusions of the statement of position should be applied by adjusting opening fund balances for the initial application period. When financial statements for periods prior to adoption are presented, they should be restated to reflect the prior-period adjustments. The nature of the restatements and their effects should be disclosed in the period of change.

APPENDIX A

.126 Glossary

A number of terms used throughout this document are commonly used by nonprofit organizations and, because these terms have specialized meaning, this glossary is included.

accessions Additions, both purchased and donated, to collections held by museums, art galleries, botanical gardens, libraries, and similar entities.

agency fund *See* custodian funds.

annuity gift A gift of money or other property given to an organization on the condition that the organization bind itself to make periodic stipulated payments that terminate at a specified time to the donor or other designated individuals.

auxiliary activity An activity providing a service that is not part of the basic program services of the organization. A fee is normally charged that is directly related to, although not necessarily equal to, the cost of the service.

capital additions Gifts, grants, bequests, investment income, and gains and losses on investments restricted either permanently or for a period of time by parties outside of the organization to endowment and loan funds. Capital additions also include similar resources restricted for fixed asset additions but only to the extent expended during the year.

collections Works of art, botanical and animal specimens, books, and other items held for display or study by museums and similar institutions.

custodian funds Funds received and held by an organization as fiscal agent for others.

deaccessions Dispositions of items in collections held by museums, art galleries, botanical gardens, libraries, and similar entities.

deferred capital additions Capital additions received or recorded before the related restrictions are met. *See also* capital additions.

deferred revenue and support Revenue or support received or recorded before it is earned, that is, before the conditions are met, in whole or in part, for which the revenue or support is received or is to be received.

designated funds Unrestricted funds set aside for specific purposes by action of the governing board. *See also* quasi-endowment funds.

encumbrances Commitments in the form of orders, contracts, and similar items that will become payable when goods are delivered or services rendered.

endowment fund A fund in which a donor has stipulated in the donative instrument that the principal is to be maintained inviolate and in perpetuity and only the income from the investments of the fund may be expended. *See also* term endowment.

expendable funds Funds that are available to finance an organization's program and supporting services, including both unrestricted and restricted amounts.

functional classification A classification of expenses that accumulates expenses according to the purpose for which costs are incurred. The primary functional classifications are program and supporting services.

fund An accounting entity established for the purpose of accounting for resources used for specific activities or objectives in accordance with special regulations, restrictions, or limitations.

fund group A group of funds of similar character, for example, operating funds, endowment funds, and annuity and life income funds.

funds held in trust by others Resources held and administered, at the direction of the donor, by an outside trustee for the benefit of the organization.

investment pool Assets of several funds pooled or consolidated for investment purposes.

life income agreement An agreement whereby money or other property is given to an organization on the condition that the organization bind itself to pay periodically to the donor or other designated individual the income earned by the assets donated to the organization for the lifetime of the donor or of the designated individual.

loan funds Resources restricted for loans. When both principal and interest on the loan funds received by the organization are loanable, they are included in the loan-fund group. If only the income from a fund is loanable, the principal is included in endowment funds, while the cumulative income constitutes the loan fund.

natural expense classification *See* object classification of expenses.

net investment in plant The total carrying value of all property, plant, equipment, and related liabilities, exclusive of those real properties that are held for investment.

nonexpendable additions *See* capital additions.

object classification of expenses A method of classifying expenditures according to their natural classification, such as salaries and wages, employee benefits, supplies, purchased services, and so forth.

pledge A promise to make a contribution to an organization in the amount and form stipulated.

quasi-endowment funds Funds that the governing board of an organization, rather than a donor or other outside agency, has determined are to be retained and invested. The governing board has the right to decide at any time to expend the principal of such funds. *See also* designated funds.

restricted funds Funds whose use is restricted by outside agencies or persons as contrasted with funds over which the organization has complete control and discretion.

revenues Gross increases in assets, gross decreases in liabilities, or a combination of both from delivering or producing goods, rendering services, or other earning activities of an organization during a period, for example, dues, sale of services, ticket sales, fees, interest, dividends, and rent.

support The conveyance of property from one person or organization to another without consideration, for example, donations, gifts, grants, or bequests.

term endowment A fund that has all the characteristics of an endowment fund, except that at some future date or event it will no longer be required to be maintained as an endowment fund.

transfer Moving fund balances from one fund to another, usually as a result of an intended change in the use of assets.

unrestricted funds Funds that have no external restriction on their use or purpose, that is, funds that can be used for any purpose designated by the governing board as distinguished from funds restricted externally for specific purposes (for example, for operations, plant, and endowment).

APPENDIX B

.127 Illustrative Allocation Procedures Under Paragraph .100

Although the following allocation procedures are illustrative only, using them or similar procedures ordinarily results in a reasonable allocation of an organization's multiple function expenses:

- A study of the organization's activities may be made at the start of each fiscal year to determine the best practicable allocation methods. The study should include an evaluation of the preceding year's time records or activity reports of key personnel, the use of space, the consumption of supplies and postage, and so forth. The results of the study should be reviewed periodically, and the allocation methods should be revised, if necessary, to reflect significant changes in the nature or level of the organization's current activities.
- Periodic time and expense records may be kept by employees who spend time on more than one function as a basis for allocating salaries and related costs. The records should indicate the nature of the activities in which the employee is involved. If the functions do not vary significantly from period to pe-

riod, the preparation of time reports for selected test periods during the year might be sufficient.

- Automobile and travel costs may be allocated on the basis of the expense or time reports of the employees involved.
- Telephone expense may be allocated on the basis of use by extensions, generally following the charge assigned to the salary of the employee using the telephone, after making direct charges for the toll calls or other service attributable to specific functions.
- Stationery, supplies, and postage costs may be allocated based on a study of their use.
- Occupancy costs may be allocated on the basis of a factor determined from a study of the function of the personnel using the space involved.
- Depreciation and rental of equipment may be allocated based on asset usage.

APPENDIX C

.128 Illustrative Financial Statements

The following illustrative financial statements (exhibits 1 through 13) demonstrate the practical applications of the reporting practices discussed in this statement of position. Specific types of nonprofit organizations have been selected to illustrate a wide diversity of reporting practices; it is not intended that these illustrations represent either the only types of disclosure or the only statement formats that would be appropriate. Nonprofit organizations are urged to develop financial statement formats that are appropriate for their individual circumstances while being consistent with the accounting and reporting practices discussed in this document.

The notes to the financial statements in exhibit 1 are representative of the basic types of disclosure a typical nonprofit organization would include in its financial report. To avoid unnecessary repetition, the notes to the financial statements of exhibits 2 through 13 have been condensed to indicate only major topics of disclosure, except in those instances in which it is appropriate to include additional items that are unique to a particular type of nonprofit organization.

For conciseness, only some of the sample financial statements have been presented in comparative format. As noted in the text of the statement, the division encourages the presentation of comparative statements.

Index to Illustrative Financial Statements

.129 **EXHIBIT 1—INDEPENDENT SCHOOL**

EXHIBIT 1A

Sample Independent School

Balance Sheet

June 30, 19X1

	Operating Funds	*Plant Funds*	*Endowment Funds*	*Total All Funds*
Assets				
Cash	$ 87,000	$ 15,000	$ 19,000	$ 121,000
Accounts receivable, less allowance for doubtful receivables of $3,000	34,000	—	—	34,000
Pledges receivable, less allowance for doubtful pledges of $10,000	—	75,000	—	75,000
Inventories, at lower of cost (FIFO) or market	7,000	—	—	7,000
Investments (Note 2)	355,000	10,000	100,000	465,000
Land, buildings, equipment, and library books, at cost less accumulated depreciation of $980,000 (Note 3)	—	2,282,000	—	2,282,000
Other assets	17,000	—	—	17,000
Total assets	$500,000	$2,382,000	$119,000	$3,001,000
Liabilities and Fund Balances				
Accounts payable and accrued expenses	$ 13,000	—	—	$ 13,000
Deferred amounts (Note 6)				
Unrestricted	86,000	—	—	86,000
Restricted	27,000	$ 100,000	—	127,000
Long-term debt (Note 4)	—	131,000	—	131,000
Total liabilities	126,000	231,000	—	357,000
Fund balances				
Unrestricted				
Designated by the governing board for long-term investment	355,000	—	—	355,000
Undesignated	19,000	—	—	19,000
	374,000	—	—	374,000
Restricted—nonexpendable	—	—	$119,000	119,000
Net investment in plant	—	2,151,000	—	2,151,000
Total fund balances	374,000	2,151,000	119,000	2,644,000
Total liabilities and fund balances	$500,000	$2,382,000	$119,000	$3,001,000

EXHIBIT 1B

Sample Independent School

Statement of Support and Revenue, Expenses, Capital Additions, and Changes in Fund Balances

Year Ended June 30, 19X1

	Operating Funds Unrestricted	*Operating Funds* Restricted	*Total*	*Plant Funds*	*Endowment Funds*	*Total All Funds*
Support and revenue						
Tuition and fees	$ 910,000	—	$ 910,000	—	—	$ 910,000
Contributions	104,000	$80,500	184,500	—	—	184,500
Endowment and other investment income	23,000	1,500	24,500	—	—	24,500
Net loss on investment transactions	(8,000)	—	(8,000)	—	—	(8,000)
Auxiliary activities	25,000	—	25,000	—	—	25,000
Summer school and other programs	86,000	—	86,000	—	—	86,000
Other sources	26,000	—	26,000	—	—	26,000
Total support and revenue	1,166,000	82,000	1,248,000	—	—	1,248,000
Expenses						
Program services						
Instruction and student activities	798,000	43,000	841,000	$ 69,000	—	910,000
Auxiliary activities	24,000	—	24,000	—	—	24,000
Summer school and other programs	91,000	—	91,000	7,000	—	98,000
Financial aid	—	37,000	37,000	3,000	—	40,000
Total program services	913,000	80,000	993,000	79,000	—	1,072,000

Supporting services						
General administration	147,000	2,000	149,000	13,000	—	162,000
Fund raising	12,000	—	12,000	1,000	—	13,000
Total supporting services	159,000	2,000	161,000	14,000	—	175,000
Total expenses	1,072,000	82,000	1,154,000	93,000	—	1,247,000
Excess (deficiency) of support and revenue over expenses before capital additions	94,000	—	94,000	(93,000)	—	1,000
Capital additions						
Contributions and bequests	—	—	—	80,000	$ 30,000	110,000
Investment income	—	—	—	5,000	—	5,000
Net gain on investment transactions	—	—	—	1,000	2,000	3,000
Total capital additions	—	—	—	86,000	32,000	118,000
Excess (deficiency) of support and revenue over expenses after capital additions	94,000	—	94,000	(7,000)	32,000	119,000
Fund balances at beginning of year	387,000	—	387,000	2,047,000	91,000	2,525,000
Transfers						
Equipment acquisitions and principal debt service payments	(111,000)	—	(111,000)	111,000	—	—
Realized gains on endowment funds utilized	4,000	—	4,000	—	(4,000)	—
Fund balances at end of year	$ 374,000	—	$ 374,000	$2,151,000	$119,000	$2,644,000

EXHIBIT 1C

Sample Independent School

Statement of Changes in Financial Position

Year Ended June 30, 19X1

	Operating Funds	*Plant Funds*	*Endowment Funds*	*Total All Funds*
Resources provided				
Excess (deficiency) of support and revenue over expenses before capital additions	$ 94,000	$ (93,000)	—	$ 1,000
Capital additions				
Contributions and bequests	—	80,000	$ 30,000	110,000
Investment income	—	5,000	—	5,000
Net gain on investments	—	1,000	2,000	3,000
Excess (deficiency) of support and revenue over expenses after capital additions	94,000	(7,000)	32,000	119,000
Items not using (providing) resources				
Provision for depreciation	—	93,000	—	93,000
Net (gain) loss on investment transactions	8,000	(1,000)	(2,000)	5,000
Decrease in inventories	2,000	—	—	2,000
Increase in deferred amounts	3,000	75,000	—	78,000
Proceeds from sale of investments	160,000	2,000	47,000	209,000
Total resources provided	267,000	162,000	77,000	506,000
Resources used				
Purchases of equipment	—	145,000	—	145,000
Reduction of long-term debt	—	52,000	—	52,000
Purchases of investments	210,000	6,000	136,000	352,000
Increase in other assets	1,000	—	—	1,000
Increase in accounts and pledges receivable	3,000	60,000	—	63,000
Decrease in accounts payable and accrued expenses	3,000	—	—	3,000
Total resources used	217,000	263,000	136,000	616,000
Transfers				
Equipment acquisitions and principal debt service payments	(111,000)	111,000	—	—
Realized gains on endowment funds utilized	4,000	—	(4,000)	—
Total transfers	(107,000)	111,000	(4,000)	—
Increase (decrease) in cash	$ (57,000)	$ 10,000	$ (63,000)	$(110,000)

EXHIBIT 1D

Sample Independent School

Notes to Financial Statements

Year Ended June 30, 19X1

Note 1—Summary of Significant Accounting Policies

The financial statements of Sample Independent School have been prepared on the accrual basis. The significant accounting policies followed are described below to enhance the usefulness of the financial statements to the reader.

Fund Accounting

To ensure observance of limitations and restrictions placed on the use of resources available to the school, the accounts of the school are maintained in accordance with the principles of fund accounting. This is the procedure by which resources for various purposes are classified for accounting and reporting purposes into funds established according to their nature and purposes. Separate accounts are maintained for each fund; however, in the accompanying financial statements, funds that have similar characteristics have been combined into fund groups. Accordingly, all financial transactions have been recorded and reported by fund group.

The assets, liabilities, and fund balances of the school are reported in three self-balancing fund groups as follows:

- Operating funds, which include unrestricted and restricted resources, represent the portion of expendable funds that is available for support of school operations.
- Plant funds represent resources restricted for plant acquisitions and funds expended for plant.
- Endowment funds represent funds that are subject to restrictions of gift instruments requiring in perpetuity that the principal be invested and the income only be used.

Expendable Restricted Resources

Operating and plant funds restricted by the donor, grantor, or other outside party for particular operating purposes or for plant acquisitions are deemed to be earned and reported as revenues of operating funds or as additions to plant funds, respectively, when the school has incurred expenditures in compliance with the specific restrictions. Such amounts received but not yet earned are reported as restricted deferred amounts.

Plant Assets and Depreciation

Uses of operating funds for plant acquisitions and principal debt service payments are accounted for as transfers to plant funds. Proceeds from the sale of plant assets, if unrestricted, are transferred to operating fund balances, or, if restricted, to deferred amounts restricted for plant acquisitions. Depreciation of buildings and equipment is provided over the estimated useful lives of the respective assets on a straight-line basis.

Other Matters

All gains and losses arising from the sale, collection, or other disposition of investments and other noncash assets are accounted for in the fund that owned the assets. Ordinary income from investments, receivables, and the like is accounted for in the fund owning the assets, except for income derived from investments of endowment funds, which is accounted for, if unrestricted, as revenue of the expendable operating fund or, if restricted, as deferred amounts until the terms of the restriction have been met.

Legally enforceable pledges less an allowance for uncollectible amounts are recorded as receivables in the year made. Pledges for support of current operations are recorded as operating fund support. Pledges for support of future operations and plant acquisitions are recorded as deferred amounts in the respective funds to which they apply.

Note 2—Investments

Investments are presented in the financial statements in the aggregate at the lower of cost (amortized, in the case of bonds) or fair market value.

	Cost	*Market*
Operating funds	$355,000	$365,000
Plant funds	10,000	11,000
Endowment funds	100,000	109,000
	$465,000	$485,000

Investments are composed of the following:

	Cost	*Market*
Corporate stocks and bonds	$318,000	$320,000
U.S. government obligations	141,000	159,000
Municipal bonds	6,000	6,000
	$465,000	$485,000

The following tabulation summarizes the relationship between carrying values and market values of investment assets.

	Carrying Value	*Market Value*	*Excess of Market Over Cost*
Balance at end of year	$465,000	$485,000	$ 20,000
Balance at beginning of year	$327,000	$335,000	8,000
Increase in unrealized appreciation			12,000
Realized net loss for year			(5,000)
Total net gain for year			$ 7,000

The average annual yield exclusive of net gains (losses) was 7% and the annual total return based on market value was 9% for the year ended June 30, 19X1.

Note 3—Plant Assets and Depreciation

A summary of plant assets follows.

Land	$ 255,000
Buildings	2,552,000
Equipment	340,000
Library books	115,000
	3,262,000
Less accumulated depreciation	980,000
	$2,282,000

Note 4—Long-Term Debt

A summary of long-term debt follows.

7½% unsecured notes payable to bank due in quarterly installments of $2,500	$ 29,000
8½% mortgage payable in semiannual installments of $3,500 through 19X7	102,000
	$131,000

Note 5—Pension Plans

The school has noncontributory pension plans covering all personnel. Total pension expense for the year ended June 30, 19X1, was $60,000, which includes amortization of prior service costs over a period of twenty years. The school's policy is to fund pension costs accrued. The actuarially computed value of vested benefits as of June 30, 19X1, exceeds net assets of the pension fund by approximately $100,000.

Note 6—Changes in Deferred Restricted Amounts

	Operating Funds	*Plant Fund*
Balances at beginning of year	$ 24,000	$ 25,000
Additions		
Contributions and bequests	79,000	158,000
Investment income	6,000	1,000
Net gain on investment transactions	—	2,000
	109,000	186,000
Deductions—funds expended during the year	82,000	86,000
Balances at end of year	$ 27,000	$100,000

Note 7—Functional Allocation of Expenses

The costs of providing the various programs and other activities have been summarized on a functional basis in the statement of support and revenue, expenses, capital additions, and changes in fund balances. Accordingly, certain costs have been allocated among the programs and supporting services benefited.

Note 8—Commitments

The school has entered into various agreements aggregating approximately $80,000 for the purchase of equipment to be received subsequent to June 30, 19X1.

.130 **EXHIBIT 2—CEMETERY ORGANIZATION**

EXHIBIT 2A

Sample Cemetery Organization

Balance Sheet

June 30, 19X1, and 19X0

Assets	*19X1*	*19X0*	**Liabilities and Fund Balance**	*19X1*	*19X0*
Current			Current		
Cash	$ 47,000	$ 27,000	Accounts payable	$ 90,000	$ 41,000
Receivables, net	15,000	15,000	Accrued expenses	12,000	8,000
Inventory of supplies	55,000	46,000	Portion of long-term debt		
Prepaid expenses	4,000	3,000	currently due	30,000	30,000
Total current assets	121,000	91,000	Total current liabilities	132,000	79,000
Inventory			Long-term debt (Note 4)	240,000	270,000
Investment in real estate	370,000	370,000			
Space development	197,000	110,000			
Total inventory	567,000	480,000			
Property, plant, and equipment,			Fund balance	404,000	397,000
at cost (Note 2)					
Land, other than burial spaces	125,000	125,000			
Buildings	105,000	105,000			
Equipment	75,000	70,000			
	305,000	300,000			
Less accumulated depreciation	217,000	125,000			
Fixed assets, net	88,000	175,000			
Total	$776,000	$746,000	Total	$776,000	$746,000

EXHIBIT 2B

Sample Cemetery Organization

Statement of Revenue and Expenses

Years Ended June 30, 19X1, and 19X0

	19X1	*19X0*
Revenue		
Net sales		
Spaces	$210,000	$201,000
Memorials and inscriptions	36,000	30,000
Interment fees	20,000	14,000
Other fees	6,000	2,000
Total	272,000	247,000
Cost of sales		
Spaces	150,000	151,000
Memorials	19,000	14,000
Burial services	16,000	13,000
Total	185,000	178,000
Gross margin	87,000	69,000
Expenses		
Maintenance	60,000	50,000
General administration	30,000	18,000
Commissions	10,000	9,000
Total	100,000	77,000
Operating margin	(13,000)	(8,000)
Other revenue		
Income from care and maintenance funds (Note 3)	20,000	13,000
Excess of revenue over expenses	7,000	5,000
Fund balance—beginning	397,000	392,000
Fund balance—ending	$404,000	$397,000

EXHIBIT 2C

Sample Cemetery Organization

Statement of Changes in Financial Position

Years Ended June 30, 19X1, and 19X0

	19X1	19X0
Source of cash		
Excess of revenue over expenses	$ 7,000	$ 5,000
Charges not requiring (providing) cash in the current period—depreciation and amortization	92,000	74,000
Cash provided from operations	99,000	79,000
Increases in accounts payable and accrued expenses	53,000	14,000
Total sources of cash	152,000	93,000
Uses of cash		
Space development and equipment	92,000	40,000
Increase in accounts receivable	—	15,000
Reduction of long-term debt	30,000	30,000
Increase in supplies and prepaid expenses	10,000	2,000
Total uses of cash	132,000	87,000
Increases in cash	20,000	6,000
Cash, beginning of year	27,000	21,000
Cash, end of year	$ 47,000	$ 27,000

EXHIBIT 2D

Sample Cemetery Organization

Notes to Financial Statements*

June 30, 19X1, and 19X0

Note 1—Summary of Significant Accounting Policies

(In addition to the policy disclosures illustrated in Note 1 of exhibit 1, the following are typical of additional disclosures to be considered for this type of organization.)

Revenue Recognition

Sales of spaces are recorded when contracts of sales are signed.

Cost of Spaces Sold

The cost of each space sold is computed based on allocation of total expenses incurred in developing the cemetery.

Note 2—Property, Plant, and Equipment

Note 3—Maintenance Funds

General Maintenance

Under the State Cemetery Act, Sample Cemetery is required, among other things, to collect and pay into a general maintenance fund the following fees and charges:

Fifteen percent (15%) of the gross sales price of each plot sold.
Ten dollars ($10) for each interment.
Five cents ($.05) per square unit of surface area of the base of a memorial.

The general maintenance fund principal is restricted by the State Cemetery Act for major improvements and repairs and, accordingly, is not included in the financial statements. At June 30, 19X1, and 19X0 this fund amounted to $383,000 and $338,000, respectively. Investment income is unrestricted and is included in other income.

Specific Trusts

Specific trust funds are restricted for flowers, seeding, sodding, and other maintenance of the specific plots as prescribed by the external source and are not available for general use by the cemetery. During the years ended

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

June 30, 19X1, and June 30, 19X0, $11,000 and $2,000, respectively, were expended for specific trust maintenance and have been reflected in the statement of revenue and expense.

Note 4—Long-Term Debt

Note 5—Functional Allocation of Expenses

Note 6—Commitments

.131 EXHIBIT 3—COUNTRY CLUB

EXHIBIT 3A
Sample Country Club
Balance Sheet
March 31, 19X1, and 19X0

	19X1	*19X0*
Assets		
Current assets		
Cash	$ 44,413	$ 37,812
Investments (Note 2)	289,554	388,007
Accounts receivable, less allowances of $5,000 in 19X1, and $6,000 in 19X0	71,831	45,898
Inventories, at lower of cost (FIFO) or market	27,930	28,137
Prepaid expenses	19,154	13,948
Total current assets	452,882	513,802
Property and equipment, at cost (Note 3)		
Land and land improvements	1,085,319	1,098,828
Buildings	1,331,590	1,200,585
Furniture, fixtures, and equipment	274,761	254,540
	2,691,670	2,553,953
Less accumulated depreciation	864,564	824,088
	1,827,106	1,729,865
Other assets		
Deferred charges	15,077	16,524
Beverage license	10,500	10,500
	25,577	27,024
	$2,305,565	$2,270,691
Liabilities and Membership Equity		
Current liabilities		
Accounts payable and accrued expenses	$ 61,426	$ 63,600
Deferred revenues—initiation fees (Note 1)	15,677	7,755
Due to resigned members	16,400	12,900
Taxes	20,330	23,668
Total current liabilities	113,833	107,923
Membership equity		
Proprietary certificates, 500 at $1,500 each—no change during the years	750,000	750,000
Cumulative excess of revenue over expenses	1,441,732	1,412,768
	2,191,732	2,162,768
	$2,305,565	$2,270,691

EXHIBIT 3B

Sample Country Club

Statement of Revenue, Expenses, and Changes in Cumulative Excess of Revenue Over Expenses

Years Ended March 31, 19X1, and 19X0

	19X1	19X0
Revenue		
Dues	$ 590,000	$ 600,000
Restaurant and bar charges	270,412	265,042
Greens fees	171,509	163,200
Tennis and swimming fees	83,829	67,675
Initiation fees	61,475	95,220
Locker and room rentals	49,759	49,954
Interest and discounts	28,860	28,831
Golf cart rentals	26,584	24,999
Other—net	4,011	3,893
Total revenue	1,286,439	1,298,814
Expenses		
Greens	241,867	244,823
House	212,880	210,952
Restaurant and bar	153,035	136,707
Tennis and swimming	67,402	48,726
General and administrative	533,838	690,551
Net (gains) losses on investments	98,453	(98,813)
Total expenses	1,307,475	1,232,946
Excess (deficiency) of revenue over expenses before capital additions	(21,036)	65,868
Capital additions		
Assessments for capital improvements	50,000	—
Excess (deficiency) of revenue over expenses after capital additions	28,964	65,868
Cumulative excess of revenue over expenses—beginning of year	1,412,768	1,346,900
Cumulative excess of revenue over expenses—end of year	$1,441,732	$1,412,768

EXHIBIT 3C

Sample Country Club

Statement of Changes in Financial Position

Years Ended March 31, 19X1, and 19X0

	19X1	*19X0*
Sources of funds		
Excess (deficiency) of revenue over expenses before capital additions	$ (21,036)	$ 65,868
Capital additions	50,000	—
Excess (deficiency) of revenue over expenses after capital additions	28,964	65,868
Add-back provision for depreciation, which does not affect working capital	40,476	61,618
Total from operations	69,440	127,486
Decrease in deferred charges—net	1,447	—
Total sources	70,887	127,486
Applications of funds		
Purchases of property and equipment	137,717	84,377
Increase in deferred charges—net	—	8,909
Total applications	137,717	93,286
Increase (decrease) in working capital	$ (66,830)	$ 34,200
Changes in the components of working capital are summarized as follows:		
Increase (decrease) in current assets		
Cash	$ 6,601	$ (70,928)
Investments	(98,453)	98,813
Accounts receivable	25,933	5,000
Inventories	(207)	8,112
Prepaid expenses	5,206	2,056
	(60,920)	43,053
(Increase) decrease in current liabilities		
Accounts payable and accrued expenses	2,174	(5,597)
Deferred revenues—initiation fees	(7,922)	(3,517)
Due to resigned members	(3,500)	(2,700)
Taxes	3,338	2,961
	(5,910)	(8,853)
Increase (decrease) in working capital	$ (66,830)	$ 34,200

EXHIBIT 3D

Sample Country Club

Notes to Financial Statements*

March 31, 19X1, and 19X0

Note 1—Summary of Significant Accounting Principles

(In addition to the policy disclosures illustrated in Note 1 of exhibit 1, the following are typical of additional disclosures to be considered for this type of organization.)

Membership Dues and Initiation Fees

Membership dues are recognized as revenue in the applicable membership period. Initiation fees are recorded as revenue in the period when the fees are due.

Note 2—Investments

Note 3—Property and Equipment and Depreciation

Note 4—Pension Plans

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

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EXHIBIT 4—LIBRARY

EXHIBIT 4A

Sample Library
Balance Sheet
December 31, 19X1
(With Comparative Totals for 19X0)

	December 31, 19X1							December 31, 19X0
	Unrestricted			Current				
	Operating	*Investment*	*Total*	*Restricted*	*Plant*	*Endowment*	*Total*	*Total*
Assets								
Current assets								
Cash, including interest-bearing accounts of $600,000 in 19X1, and $400,000 in 19X0	$ 690,000	—	$ 690,000	$ 3,000	$ 7,000	—	$ 700,000	$ 411,000
Certificates of deposit	375,000	—	375,000	75,000	—	—	450,000	525,000
Grants receivable (Note 1)								
Governments	120,000	—	120,000	—	—	—	120,000	161,000
Other	30,000	—	30,000	27,000	8,000	—	65,000	35,000
Pledges receivable, at estimated net realizable value (Note 1)	15,000	—	15,000	—	—	—	15,000	15,000
Prepaid expenses and other current assets	70,000	—	70,000	—	—	—	70,000	85,000
Total current assets	1,300,000	—	1,300,000	105,000	15,000	—	1,420,000	1,232,000
Investments—at market (Note 2)	—	$920,000	920,000	—	165,000	$985,000	2,070,000	2,172,000
Land, buildings, and equipment—at cost, less accumulated depreciation of $90,000 and $79,000, respectively (Note 3)	—	—	—	—	1,525,000	—	1,525,000	1,491,000
Inexhaustible collections and books (Note 1)	—	—	—	—	—	—	—	—
Total assets	$1,300,000	$920,000	$2,220,000	$105,000	$1,705,000	$985,000	$5,015,000	$4,895,000

Liabilities and Fund Balances

Current liabilities								
Accounts payable, accrued expenses, and current portion of long-term debt	$ 200,000	—	$ 200,000	—	$ 10,000	—	$ 210,000	$ 130,000
Deferred restricted contributions, etc. (Note 6)	—	—	—	$105,000	5,000	—	110,000	100,000
Total current liabilities	200,000	—	200,000	105,000	15,000	—	320,000	230,000
Long-term debt (Note 4)	—	—	—	—	180,000	—	180,000	190,000
Total liabilities	200,000	—	200,000	105,000	195,000	—	500,000	420,000
Fund balances								
Unrestricted								
Designated by the board for								
Investment	—	$920,000	920,000	—	—	—	920,000	740,000
Purchase of equipment	50,000	—	50,000	—	—	—	50,000	35,000
Undesignated	1,050,000	—	1,050,000	—	1,510,000	—	2,560,000	2,725,000
Restricted	—	—	—	—	—	$985,000	985,000	975,000
Total fund balances	1,100,000	920,000	2,020,000	—	1,510,000	985,000	4,515,000	4,475,000
Total liabilities and fund balances	$1,300,000	$920,000	$2,220,000	$105,000	$1,705,000	$985,000	$5,015,000	$4,895,000

EXHIBIT 4B

Sample Library

Statement of Support, Revenue, and Expenses and Changes in Fund Balances

Year Ended December 31, 19X1
(With Comparative Totals for 19X0)

	Year Ended December 31, 19X1							Year Ended December 31, 19X0
	Unrestricted			*Current*				
	Operating	*Investment*	*Total*	*Restricted*	*Plant*	*Endowment*	*Total*	*Total*
Support and revenue								
Support								
Grants (Note 1)								
Governments	$ 150,000	—	$ 150,000	—	—	—	$ 150,000	$ 150,000
Other	25,000	—	25,000	—	—	—	25,000	—
Contributions, legacies, and bequests (Note 1)	350,000	$ 90,000	440,000	$75,000	—	—	515,000	490,000
Contributed services of volunteers (Note 1)	75,000	—	75,000	—	—	—	75,000	50,000
Use of contributed facilities (Note 1)	47,000	—	47,000	—	—	—	47,000	50,000
Total support	647,000	90,000	737,000	75,000	—	—	812,000	740,000
Revenue								
Fees for services	50,000	—	50,000	—	—	—	50,000	45,000
Book rentals and fines	320,000	—	320,000	—	—	—	320,000	250,000
Investment income including net gains	25,000	93,000	118,000	10,000	—	—	128,000	103,000
Total revenue	395,000	93,000	488,000	10,000	—	—	498,000	398,000
Total support and revenue	1,042,000	183,000	1,225,000	85,000	—	—	1,310,000	1,138,000

Expenses (Note 7)								
Program services								
Circulating library	390,000	—	390,000	75,000	$ 5,000	—	470,000	430,000
Research library	169,000	—	169,000	—	1,000	—	170,000	155,000
Collections and exhibits	49,000	—	49,000	10,000	1,000	—	60,000	50,000
Educational services	49,000	—	49,000	—	1,000	—	50,000	55,000
Community services	29,500	—	29,500	—	500	—	30,000	20,000
Total program services	686,500	—	686,500	85,000	8,500	—	780,000	710,000
Supporting services								
General administration	315,500	3,000	318,500	—	21,500	—	340,000	290,000
Fund raising	200,000	—	200,000	—	5,000	—	205,000	200,000
Total supporting services	515,500	3,000	518,500	—	26,500	—	545,000	490,000
Total expenses	1,202,000	3,000	1,205,000	85,000	35,000	—	1,325,000	1,200,000
Excess (deficiency) of support and revenue over expenses before capital additions	(160,000)	180,000	20,000	—	(35,000)	—	(15,000)	(62,000)
Capital additions								
Contributions	—	—	—	—	40,000	—	40,000	95,000
Investment income including net gains	—	—	—	—	5,000	—	5,000	17,000
Contributed materials, equipment, etc. (Note 1)	—	—	—	—	10,000	—	10,000	—
	—	—	—	—	55,000	—	55,000	112,000
Excess (deficiency) of support and revenue over expenses after capital additions	(160,000)	180,000	20,000	—	20,000	—	40,000	50,000
Fund balances at beginning of year	1,270,000	740,000	2,010,000	—	1,480,000	$985,000	4,475,000	4,425,000
Mandatory transfers—principal of indebtedness	(10,000)	—	(10,000)	—	10,000	—	—	—
Fund balances at end of year	$1,100,000	$920,000	$2,020,000	—	$1,510,000	$985,000	$4,515,000	$4,475,000

EXHIBIT 4C

Sample Library

Statement of Changes in Financial Position

Year Ended December 31, 19X1 (With Comparative Totals for 19X0)

	Year Ended December 31, 19X1						Year Ended December 31, 19X0
	Unrestricted						
	Operating	*Investment*	*Total*	*Current Restricted*	*Plant*	*Total*	*Total*
Sources of working capital							
Excess (deficiency) of support and revenue over expenses before capital additions	$(160,000)	$180,000	$ 20,000	—	$(35,000)	$ (15,000)	$ (62,000)
Capital additions	—	—	—	—	55,000	55,000	112,000
Excess (deficiency) of support and revenue over expenses after capital additions	(160,000)	180,000	20,000	—	20,000	40,000	50,000
Add (deduct) items not using (providing) working capital							
Depreciation	—	—	—	—	11,000	11,000	11,000
Contributed equipment	—	—	—	—	(10,000)	(10,000)	—
Working capital provided by operations	(160,000)	180,000	20,000	—	21,000	41,000	61,000
Deferred restricted contributions and investment income received	—	—	—	$85,000	—	85,000	100,000
Sale of investments	22,000	245,000	267,000	—	—	267,000	110,000
	(138,000)	425,000	287,000	85,000	21,000	393,000	271,000

Uses of working capital							
Purchase of investments	—	—	—	—	165,000	165,000	—
Purchase of fixed assets	—	—	—	—	35,000	35,000	35,000
Reduction of long-term debt	—	—	—	—	10,000	10,000	10,000
Deferred restricted contributions and investment income recognized as support	—	—	—	85,000	—	85,000	100,000
Transfers between funds	10,000	—	10,000	—	(10,000)	—	—
	10,000	—	10,000	85,000	200,000	295,000	145,000
Increase (decrease) in working capital	$(148,000)	$425,000	$277,000	—	$(179,000)	$ 98,000	$126,000
Changes in working capital components							
Increase (decrease) in current assets							
Cash	$(129,000)	$425,000	$296,000	$ (7,000)	—	$289,000	$ (5,000)
Certificates of deposit	22,000	—	22,000	20,000	$(117,000)	(75,000)	61,000
Grants receivable	54,000	—	54,000	(8,000)	(57,000)	(11,000)	60,000
Pledges receivable	—	—	—	—	—	—	(5,000)
Prepaid expenses and other current assets	(15,000)	—	(15,000)	—	—	(15,000)	—
	(68,000)	425,000	357,000	5,000	(174,000)	188,000	111,000
(Increase) decrease in current liabilities							
Accounts payable, accrued expenses, and current portion of long-term debt	(80,000)	—	(80,000)	—	—	(80,000)	15,000
Deferred restricted contributions, etc.	—	—	—	(5,000)	(5,000)	(10,000)	—
Increase (decrease) in working capital	$(148,000)	$425,000	$277,000	—	$(179,000)	$ 98,000	$126,000

EXHIBIT 4D

Sample Library

Notes to Financial Statements*

December 31, 19X1

Note 1—Summary of Significant Accounting Policies

(In addition to the policy disclosures illustrated in Note 1 of exhibit 1, the following are typical of additional disclosures to be considered for this type of organization.)

Contributed Facilities

The library occupies without charge certain premises located in government-owned buildings. The estimated fair rental value of the premises is reported as support and expense in the period in which the premises are used.

Grants

The library records income from unrestricted grants in the period designated by the grantor.

Inexhaustible Collections and Books

Because the values of the existing inexhaustible collections, including research books, are not readily determinable, the library has not capitalized them. Collections that are exhaustible are capitalized and included with equipment in the financial statements and are amortized over their estimated useful lives. Accessions and deaccessions during 19X0 and 19X1 were not significant. Books used in the circulating library have not been capitalized because their estimated useful lives are less than one year.

Summarized Financial Information for 19X0

The financial information for the year ended December 31, 19X0, presented for comparative purposes, is not intended to be complete financial statement presentation.

Note 2—Investments

Note 3—Plant Assets and Depreciation

Note 4—Long-Term Debt

Note 5—Pension Plans

Note 6—Changes in Deferred Restricted Amounts

Note 7—Functional Allocation of Expenses

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

Note 8—Commitments and Contingencies

The library receives a substantial amount of its support from federal, state, and local governments. A significant reduction in the level of this support, if this were to occur, may have an effect on the library's programs and activities.

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EXHIBIT 5—MUSEUM

EXHIBIT 5A

Sample Museum

Balance Sheet
June 30, 19X1
(With Comparative Totals for 19X0)

	Operating Fund	*Plant Fund*	*Endowment Fund*	*Total*	*June 30, 19X0 Total*
Assets					
Current assets					
Cash	$ 19,800	—	—	$ 19,800	$ 23,700
Receivables, less reserve of $7,700	145,500	—	—	145,500	125,800
Investments (Note 2)	210,000	—	—	210,000	—
Inventories, at lower of cost (FIFO) or market	121,100	—	—	121,100	120,600
Prepayments	26,600	—	—	26,600	12,700
Total current assets	523,000	—	—	523,000	282,800
Fixed assets, net of depreciation (Note 3)	—	$1,964,000	—	1,964,000	1,866,800
Art collection (Note 11)					
Cash held for investment	—	—	$ 6,000	6,000	3,800
Investments (Note 2)	4,044,500	—	7,688,400	11,732,900	11,709,300
Total	$4,567,500	$1,964,000	$7,694,400	$14,225,900	$13,862,700

Liabilities and Fund Balances					
Current liabilities					
Accounts payable and accrued expenses	$ 256,900	—	—	$ 256,900	$ 252,900
Deferred revenue and restricted gifts, current portion (Note 5)	242,100	—	—	242,100	208,100
Total current liabilities	499,000	—	—	499,000	461,000
Deferred revenue and restricted gifts, noncurrent portion (Note 5)	409,900	—	—	409,900	167,300
Fund balances					
Endowment	—	—	$7,694,400	7,694,400	7,621,800
Land, buildings, and equipment	—	$1,964,000	—	1,964,000	1,866,800
Unrestricted					
Designated for investment	3,490,000	—	—	3,490,000	3,490,000
Designated for plant expansion	150,000	—	—	150,000	—
Unappropriated	18,600	—	—	18,600	255,800
Total fund balances	3,658,600	1,964,000	7,694,400	13,317,000	13,234,400
Total	$4,567,500	$1,964,000	$7,694,400	$14,225,900	$13,862,700

EXHIBIT 5B

Sample Museum

Statement of Activity
Year Ended June 30, 19X1
(With Comparative Totals for 19X0)

	Operating Fund	*Plant Fund*	*Endowment Fund*	*Total*	*Year Ended June 30, 19X0 Total*
Support and revenue					
Admissions	$ 131,100	—	—	$ 131,100	$ 123,400
Government appropriations	110,700	—	—	110,700	104,000
Gifts and grants (Notes 5 and 8)	130,000	—	—	130,000	124,700
Memberships	48,400	—	—	48,400	39,900
Investment income	828,800	—	—	828,800	841,700
Net realized investment gains (losses)	6,300	—	—	6,300	(2,600)
Revenue, auxiliary activities	483,100	—	—	483,100	417,200
Total	1,738,400	—	—	1,738,400	1,648,300

Expenses					
Program					
Curatorial and conservation	578,600	$ 27,400	—	606,000	602,000
Exhibits	108,600	—	—	108,600	109,100
Education	133,400	4,800	—	138,200	131,600
Fellowships	68,200	—	—	68,200	52,800
Public information	66,400	2,700	—	69,100	67,700
Accession of art for collection, net of deaccessions (Note 11)	200,000	—	—	200,000	170,000
Supporting services					
Management and general	67,400	10,800	—	78,200	77,300
Fund raising	10,300	—	—	10,300	9,600
Cost of sales and expense of auxiliary activities	441,100	8,700	—	449,800	384,600
Total	1,674,000	54,400	—	1,728,400	1,604,700
Excess (deficiency) of support and revenue over expenses before capital additions	64,400	(54,400)	—	10,000	43,600
Capital additions					
Gifts and grants (Note 8)	—	—	$ 76,400	76,400	18,200
Net investment income	—	—	4,700	4,700	1,800
Net realized investment gains (losses)	—	—	(8,500)	(8,500)	(2,000)
Total	—	—	72,600	72,600	18,000
Excess (deficiency) of support and revenue over expenses after capital additions	64,400	(54,400)	72,600	82,600	61,600
Fund balances, beginning of period	3,745,800	1,866,800	7,621,800	13,234,400	13,172,800
Add (deduct) transfers (Note 9)	(151,600)	151,600	—	—	—
Fund balances, end of period	$3,658,600	$1,964,000	$7,694,400	$13,317,000	$13,234,400

EXHIBIT 5C

Sample Museum

Statement of Changes in Financial Position

Year Ended June 30, 19X1

Sources of working capital	
Excess of support and revenue before capital additions	$ 10,000
Capital additions	72,600
Excess of support and revenue after capital additions	82,600
Depreciation	54,400
Deferred revenue and restricted gifts received in excess of expenses incurred	242,600
Investments sold	952,200
	1,331,800
Uses of working capital	
Fixed assets purchased	151,600
Investments purchased	978,000
	1,129,600
Increase in working capital	$ 202,200
Changes in working capital, increase (decrease):	
Cash	$ (3,900)
Receivables	19,700
Investments	210,000
Inventories	500
Prepayments	13,900
Accounts payable and accrued expenses	(4,000)
Deferred revenue and restricted gifts, current portion	(34,000)
	$ 202,200

EXHIBIT 5D

Sample Museum

Notes to Financial Statements*

June 30, 19X1

Note 1—Summary of Significant Accounting Policies

Note 2—Investments

Note 3—Fixed Assets and Depreciation

Note 4—Pension Plans

Note 5—Deferred Revenue and Restricted Gifts

Note 6—Functional Allocation of Expenses

Note 7—Commitments

Note 8—Gifts Received

Note 9—Interfund Transfers

During the year ended June 30, 19X1, the trustees authorized a transfer from the Operating Fund to the Plant Fund in the amount of $151,600 representing fixed assets purchased with resources of the Operating Fund.

Note 10—Contributed Services

A substantial number of unpaid volunteers have made significant contributions of their time to develop the Museum's programs, principally in membership development and educational programs. The value of this contributed time is not reflected in these statements since it is not susceptible to objective measurement or valuation.

Note 11—Art Collection

In conformity with the practice followed by many museums, art objects purchased and donated are not included in the balance sheet.

The value of the objects acquired by gift for which the Museum can make a reasonable estimate is reported as gifts in the Statement of Activity ($28,000 in the year ended June 30, 19X1).

The cost of all objects purchased together with the value of objects acquired by gift as indicated in the preceding paragraph, less the proceeds from deaccessions of objects, is reported as a separate program expense. During the year ended June 30, 19X1, purchase of art objects amounted to $185,000 and the proceeds from deaccessions was $13,000.

Gifts of cash or other property restricted by donors for the purchase of items for the collection are classified as deferred revenue until acquisitions are made in accordance with the terms of the gifts.

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

.134 EXHIBIT 6—PERFORMING ARTS ORGANIZATION

EXHIBIT 6A

Sample Performing Arts Organization

Balance Sheet

June 30, 19X1, and 19X0

	19X1	*19X0*
Assets		
Current assets		
Cash	$216,074	$169,466
Marketable securities (Note 2)	266,330	50,967
Accounts receivable, net of allowance for doubtful accounts	70,051	26,685
Grants receivable	—	6,100
Other	39,378	13,441
Total current assets	591,833	266,659
Noncurrent assets		
Investments and endowment funds cash (Note 2)	267,869	256,648
Property and equipment at cost, net of accumulated depreciation (Note 3)	55,061	40,226
Rent and other deposits	3,839	9,130
	$918,602	$572,663
Liabilities and Entity Capital		
Current liabilities		
Accounts payable and accrued expenses	$111,150	$166,351
Deferred revenues—subscriptions (Note 1)	297,430	193,042
Deferred revenues—grants (Note 1)	42,562	—
Current portion of long-term debt	50,000	50,000
Total current liabilities	501,142	409,393
Long-term debt (Note 4)	32,000	69,740
Contingencies (Note 6)		
Entity capital		
Plant fund	33,061	38,594
Endowment funds (Note 5)	267,869	256,648
Unrestricted funds	84,530	(201,712)
	$918,602	$572,663

EXHIBIT 6B

Sample Performing Arts Organization

Statement of Activity

Years Ended June 30, 19X1, and 19X0

	19X1	*19X0*
Revenue and support from operations		
Admissions	$1,557,567	$1,287,564
Dividends and interest	21,555	2,430
Net realized gains and losses	54,700	18,300
Tuition	242,926	130,723
Concessions and other support	103,582	68,754
	1,980,330	1,507,771
Production costs	476,982	427,754
Operating expenses	797,044	685,522
Ballet school	473,658	301,722
Neighborhood productions	378,454	81,326
General and administrative expense	390,487	469,891
	2,516,625	1,966,215
Deficiency from operations	(536,295)	(458,444)
Donated services, materials, and facilities	—	8,000
Annual giving	150,379	78,469
Grants	702,368	678,322
Fund-raising costs	(35,743)	(50,454)
	817,004	714,337
Excess from current endeavors	280,709	255,893
Capital additions	11,221	18,250
Total increase in entity capital	$ 291,930	$ 274,143

EXHIBIT 6C

Sample Performing Arts Organization

Statement of Changes in Entity Capital

Years Ended June 30, 19X1, and 19X0

	Endowment Funds	*Plant Fund*	*Unrestricted Funds*	*Total*
Entity capital—June 30, 19X9	$238,398	$43,214	$(462,225)	$(180,613)
Excess from current endeavors	—	(4,620)	260,513	255,893
Capital additions	18,250	—	—	18,250
Entity capital—June 30, 19X0	256,648	38,594	(201,712)	93,530
Excess from current endeavors	—	(5,533)	286,242	280,709
Capital additions	11,221	—	—	11,221
Entity capital—June 30, 19X1	$267,869	$33,061	$ 84,530	$ 385,460

EXHIBIT 6D

Sample Performing Arts Organization

Statement of Changes in Financial Position

Years Ended June 30, 19X1, and 19X0

	19X1	*19X0*
Funds provided by		
Excess from current endeavors	$280,709	$255,893
Add expenses not requiring outlay of working capital in current period		
Depreciation	5,533	4,620
Other deferred charges	—	7,500
Funds provided from current endeavors	286,242	268,013
Increase in long-term debt	12,260	—
Other	5,291	—
Capital additions	11,221	18,250
Total funds provided	315,014	286,263
Funds applied		
Increase in noncurrent investments and cash	11,221	—
Acquisition of property, plant, and equipment	20,368	4,362
Reduction of long-term debt	50,000	25,280
Total funds applied	81,589	29,642
Increase in working capital	$233,425	$256,621
Changes in the components of working capital		
Increase (decrease) in current assets		
Cash	$ 46,608	$220,342
Marketable securities	215,363	42,312
Accounts receivable	43,366	21,269
Grants receivable	(6,100)	—
Other	25,937	15,413
Increase in current assets	325,174	299,336
(Increase) decrease in current liabilities		
Accounts payable and accrued expenses	55,201	36,149
Deferred revenues—subscriptions	(104,388)	(78,864)
Deferred revenues—grants	(42,562)	—
(Increase) in current liabilities	(91,749)	(42,715)
Increase in working capital	$233,425	$256,621

EXHIBIT 6E

Sample Performing Arts Organization

Notes to Financial Statements*

June 30, 19X1, and 19X0

Note 1—Summary of Significant Accounting Policies

Note 2—Investments

Note 3—Property and Equipment

Note 4—Long-Term Debt

Note 5—Endowments

An endowment in the amount of $125,000 required the establishment of a ballet school. The second endowment, in the amount of $100,000, established the organization's neighborhood production program. Income from those endowments, including capital gains, is to be used for those programs.

Note 6—Commitments and Contingencies

The organization leases its theatre and offices under a lease expiring in 19X8 at $25,000 per year with a renewal option for ten years at the same rent. Heating, ventilating, and air-conditioning are paid separately as common area charges. The lease is not considered a capital lease under FASB Statement 13.

Grants, bequests, and endowments require the fulfillment of certain conditions as set forth in the instrument of grant. Failure to fulfill the conditions, or in the case of endowments, failure to continue to fulfill them, could result in the return of the funds to grantors. Although that is a possibility, the Board deems the contingency remote, since by accepting the gifts and their terms, it has accommodated the objectives of the organization to the provisions of the gift.

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* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

EXHIBIT 6F

Sample Performing Arts Organization

Schedule of Functional Expenses—Supplementary Schedule

Year Ended June 30, 19X1

(With Comparative Totals for 19X0)

	Program Services					*Support Services*			
	Production Costs	*Operating Expenses*	*Ballet School*	*Neighborhood Productions*	*Total Program Services*	*General and Administrative*	*Fund Raising*	*Total Year Ended 19X1*	*Total Year Ended 19X0*
Item of Expense									
Salaries, payroll taxes, and employee benefits	$219,370	$464,570	$388,113	$306,026	$1,378,079	$260,755	$15,782	$1,654,616	$1,312,504
Professional fees	7,864	—	2,785	—	10,649	15,624	—	26,273	21,722
Supplies	15,628	17,128	—	3,728	36,484	25,823	—	62,307	43,784
Telephone	—	—	—	—	—	10,725	1,211	11,936	10,783
Postage and shipping	—	—	—	—	—	3,816	14,439	18,255	15,622
Occupancy	—	258,622	82,760	5,478	346,860	41,540	1,527	389,927	322,147
Rental and maintenance of equipment	—	56,724	—	—	56,724	6,927	2,784	66,435	52,764
Printing and publications	—	—	—	—	—	10,381	—	10,381	10,078
Travel	—	—	—	—	—	5,824	—	5,824	4,728
Conferences, conventions, and meetings	—	—	—	—	—	2,783	—	2,783	1,568
Membership dues	—	—	—	—	—	756	—	756	2,064
Scenery	154,682	—	—	35,540	190,222	—	—	190,222	143,523
Costumes	79,438	—	—	27,682	107,120	—	—	107,120	70,762
Depreciation and amortization	—	—	—	—	—	5,533	—	5,533	4,620
Total, year ended June 30, 19X1	$476,982	$797,044	$473,658	$378,454	$2,126,138	$390,487	$35,743	$2,552,368	
Total, year ended June 30, 19X0	$427,754	$685,522	$301,722	$ 81,326	$1,496,324	$469,891	$50,454		$2,016,669

.135 EXHIBIT 7—PRIVATE FOUNDATION

EXHIBIT 7A

Sample Private Foundation

Balance Sheet

December 31, 19X1, and 19X0

	19X1	*19X0*
Assets		
Cash	$ 75,000	$ 50,000
Accrued interest and dividends receivable	175,000	225,000
Securities, at market (cost, 19X1—$17,800,000; 19X0—$17,400,000) (Note 2)		
U.S. government obligations	2,000,000	1,750,000
Corporate and other obligations	5,000,000	7,000,000
Stocks	12,000,000	10,000,000
	19,000,000	18,750,000
Total assets	$19,250,000	$19,025,000
Liabilities and Fund Balance		
Federal excise taxes payable (Note 3)	$ 41,000	$ 39,000
Accrued expenses payable	9,000	11,000
Deferred taxes	10,000	5,000
Unconditional grants payable	40,000	75,000
Total liabilities	100,000	130,000
Commitments (Note 4)		
Fund balance	19,150,000	18,895,000
Total liabilities and fund balance	$19,250,000	$19,025,000

EXHIBIT 7B

Sample Private Foundation

Statement of Revenue, Expense, and Changes in Fund Balance

Years Ended December 31, 19X1, and 19X0

	19X1	*19X0*
Revenue and support		
Dividends	$ 525,000	$ 500,000
Interest	500,000	585,000
Unrestricted donations	100,000	—
Total revenue and support	1,125,000	1,085,000
Expense		
Program services		
Program grants		
Health	530,000	525,000
Education	390,000	375,000
Program management	82,500	80,000
	1,002,500	980,000
Management and general expenses	72,500	70,000
Provision for federal excise taxes	40,000	38,000
	112,500	108,000
Total expense	1,115,000	1,088,000
Excess (deficiency) of revenue and support over expense before gains (losses) on securities	10,000	(3,000)
Net gains (losses) on securities	245,000	(172,000)
Excess (deficiency) for the year	255,000	(175,000)
Fund balance, beginning of year	18,895,000	19,070,000
Fund balance, end of year	$19,150,000	$18,895,000

EXHIBIT 7C

Sample Private Foundation

Statement of Changes in Cash

Years Ended December 31, 19X1, and 19X0

	19X1	*19X0*
Sources of cash		
Excess (deficiency) for the year	$ 255,000	$ (175,000)
Net (gains) losses on securities	(245,000)	172,000
Decrease in accrued interest and dividends receivable	50,000	40,000
Proceeds on disposition of securities	5,105,000	4,000,000
	5,165,000	4,037,000
Uses of cash		
Purchase of securities	5,110,000	4,007,000
Decrease in liabilities	30,000	40,000
	5,140,000	4,047,000
Increase (decrease) in cash for year	25,000	(10,000)
Cash, beginning of year	50,000	60,000
Cash, end of year	$ 75,000	$ 50,000

EXHIBIT 7D

Sample Private Foundation

Notes to Financial Statements*

December 31, 19X1, and 19X0

Note 1—Summary of Significant Accounting Policies

(In addition to the policy disclosures illustrated in Note 1 of exhibit 1, the following are typical of additional disclosures to be considered for this type of organization.)

Office Furnishings

Costs of office furnishings and equipment are consistently charged to expense because the foundation does not deem such amounts to be sufficiently material to warrant capitalization and depreciation.

Note 2—Investment in Securities

Note 3—Federal Excise Taxes

In accordance with the applicable provisions of the Tax Reform Act of 1969, the foundation is subject to an excise tax on net investment income, including realized gains, as defined in the act. Accordingly, federal excise taxes have been accrued in amounts of $41,000 and $39,000 as of December 31, 19X1, and 19X0, respectively.

In addition, the Tax Reform Act requires that certain minimum distributions be made in accordance with a specified formula. At December 31, 19X1, the foundation had distributed approximately $200,000 more than the required minimum.

Note 4—Commitments

Trustees of the foundation had approved, as of December 31, 19X1, and 19X0, grants amounting to $750,000 and $700,000, respectively. Such grants are subject to the satisfaction by the intended recipients of prior conditions before payment. The commitments outstanding at December 31, 19X1, are scheduled for payment as follows.

Year	*Amount*
19X2	$600,000
19X3	100,000
19X4	50,000
	$750,000

Note 5—Pension Plans

Note 6—Functional Allocation of Expenses

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

.136 EXHIBIT 8—PUBLIC BROADCASTING STATION

EXHIBIT 8A

Sample Public Broadcasting Station

Balance Sheet

December 31, 19X1, and 19X0

	19X1			*19X0*
	Unrestricted	*Restricted*	*Total*	*Total*
Assets				
Current assets				
Cash	$ 78,000	$ 24,000	$ 102,000	$ 71,000
Accounts receivable, principally grants, net of allowance for doubtful accounts of $4,000 in 19X1, and $9,000 in 19X0 (Note 2)	192,000	80,000	272,000	245,000
Costs incurred for programs not yet telecast (Note 1)	117,000	74,000	191,000	176,000
Other assets	105,000	—	105,000	89,000
Total current assets	492,000	178,000	670,000	581,000
Property and equipment (Notes 1 and 3)				
Leasehold improvements, net of accumulated amortization of $154,000 in 19X1, and $94,000 in 19X0	359,000	—	359,000	374,000
Television and other equipment, net of accumulated depreciation of $672,000 in 19X1, and $407,000 in 19X0	1,568,000	—	1,568,000	1,676,000
	1,927,000	—	1,927,000	2,050,000
Total assets	$2,419,000	$178,000	$2,597,000	$2,631,000
Liabilities and Fund Balance				
Current liabilities				
Accounts payable and accrued expenses	$ 113,000	—	$ 113,000	$ 186,000
Deferred revenue for programs not yet telecast (Notes 1 and 7)	—	$178,000	178,000	270,000
Current portion of long-term debt (Note 4)	50,000	—	50,000	—
Total current liabilities	163,000	178,000	341,000	456,000
Long-term debt (Note 4)	250,000	—	250,000	300,000
Total liabilities	413,000	178,000	591,000	756,000
Fund balance	2,006,000	—	2,006,000	1,875,000
Total liabilities and fund balance	$2,419,000	$178,000	$2,597,000	$2,631,000

EXHIBIT 8B

Sample Public Broadcasting Station

Statement of Revenue, Expenses, and Changes in Fund Balance

Years Ended December 31, 19X1, and 19X0

	19X1 Unrestricted	19X1 Restricted	19X1 Total	19X0 Total
Revenue (Note 2)				
Contributions	$ 946,000	—	$ 946,000	$ 790,000
Community service grants	—	$327,000	327,000	287,000
Other grants	—	189,000	189,000	155,000
Telecasting and production	286,000	—	286,000	302,000
Facilities rental	36,000	—	36,000	31,000
Total revenue	1,268,000	516,000	1,784,000	1,565,000
Expenses				
Program services				
Programming production, including designated projects (Note 1)	274,000	335,000	609,000	563,000
Broadcasting and technical	385,000	—	385,000	279,000
Public information	162,000	—	162,000	134,000
Total program expenses	821,000	335,000	1,156,000	976,000
Supporting services				
General administration	372,000	136,000	508,000	421,000
Fund raising	146,000	45,000	191,000	154,000
Total supporting expenses	518,000	181,000	699,000	575,000
Total expenses	1,339,000	516,000	1,855,000	1,551,000
Excess (deficiency) of revenue over expenses before special grants	(71,000)	—	(71,000)	14,000
Special grants	202,000		202,000	107,000
Excess for the year	131,000		131,000	121,000
Fund balance, beginning of year	1,875,000		1,875,000	1,754,000
Fund balance, end of year	$2,006,000		$2,006,000	$1,875,000

EXHIBIT 8C

Sample Public Broadcasting Station

Statement of Changes in Financial Position

Years Ended December 31, 19X1, and 19X0

	19X1			19X0
	Unrestricted	*Restricted*	*Total*	*Total*
Financial resources were provided by				
Excess (deficiency) of revenue over expenses before special grants	$ (71,000)	—	$ (71,000)	$ 14,000
Special grants	202,000	—	202,000	107,000
Excess for the year	131,000	—	131,000	121,000
Add items not requiring working capital—amortization and depreciation	325,000	—	325,000	281,000
Working capital provided by operations	456,000	—	456,000	402,000
Increase in long-term debt	—	—	—	300,000
Total resources provided	456,000	—	456,000	702,000
Financial resources were used for				
Leasehold improvements	45,000	—	45,000	30,000
Purchases of property and equipment	157,000	—	157,000	457,000
Reduction of long-term debt	50,000	—	50,000	—
Total resources used	252,000	—	252,000	487,000
Increase in working capital	$204,000	—	$204,000	$215,000
Analysis of changes in working capital				
Increase (decrease) in current assets				
Cash	$ 57,000	$(26,000)	$ 31,000	$ 25,000
Accounts receivable	62,000	(35,000)	27,000	49,000
Costs incurred for programs not yet telecast	46,000	(31,000)	15,000	45,000
Other assets	16,000	—	16,000	21,000
	181,000	(92,000)	89,000	140,000
Decrease (increase) in current liabilities				
Accounts payable and accrued expenses	73,000	—	73,000	32,000
Deferred revenue for programs not yet telecast	—	92,000	92,000	43,000
Current portion of long-term debt	(50,000)	—	(50,000)	—
	23,000	92,000	115,000	75,000
	$204,000	—	$204,000	$215,000

EXHIBIT 8D

Sample Public Broadcasting Station

Notes to Financial Statements*

December 31, 19X1, and 19X0

Note 1—Summary of Significant Accounting Policies

(In addition to the policy disclosures illustrated in Note 1 of exhibit 1, the following are typical of additional disclosures to be considered for this type or organization.)

Programs Not Yet Telecast

Costs incurred for programs not yet telecast relate to programs that will be aired principally in the next fiscal year. Grants and contributions relating to programs not yet telecast are included as deferred revenue. As the programs are telecast, the costs incurred will be included in operating expenses and the deferred revenue will be included in revenue.

Note 2—Grants

Note 3—Property and Equipment

Note 4—Long-Term Debt

Note 5—Lease Commitments

Note 6—Retirement Plans

Note 7—Changes in Restricted Deferred Revenue

Note 8—Functional Allocation of Expenses

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

.137 EXHIBIT 9—RELIGIOUS ORGANIZATION

EXHIBIT 9A

Sample Religious Organization

Balance Sheet

December 31, 19X1

	Expendable Funds				*Nonexpendable Funds*		
Assets	*Operating*	*Deposit and Loan*	*Total*	*Plant Fund*	*Endowment*	*Annuity and Life Income*	*Total All Funds*
Cash	$1,750,000	$ 10,000	$ 1,760,000	$ 408,000	$ 20,000	$ 2,000	$ 2,190,000
Accounts receivable, less allowance for doubtful receivables of $12,000	520,000	—	520,000	—	—	—	520,000
Pledges receivable, less allowance for doubtful pledges of $25,000	500,000	—	500,000	80,000	—	—	580,000
Investments (Note 2)	3,800,000	300,000	4,100,000	260,000	1,300,000	178,000	5,838,000
Loans receivable, less allowance for doubtful loans of $350,000	—	2,600,000	2,600,000	—	—	—	2,600,000
Advances to plant funds	—	3,500,000	3,500,000	—	—	—	— *
Land, buildings, and equipment at cost, less accumulated depreciation of $23,500,000 (Note 3)	—	—	—	44,800,000	—	—	44,800,000
Other assets	150,000	—	150,000	—	—	—	150,000
Total assets	$6,720,000	$6,410,000	$13,130,000	$45,548,000	$1,320,000	$180,000	$56,678,000

Liabilities and Fund Balances							
Accounts payable and accrued expenses	$ 600,000	—	$ 600,000	$ 20,000	—	$120,000	$ 740,000
Deferred amounts (Note 6)							
Unrestricted	160,000	—	160,000	—	—	—	160,000
Restricted	870,000	—	870,000	328,000	—	60,000	1,258,000
Advances from expendable funds	—	—	—	3,500,000	—	—	— *
Deposits payable	—	$7,310,000	7,310,000	—	—	—	7,310,000
Long-term debt (Note 4)	—	—	—	2,800,000	—	—	2,800,000
Total liabilities	1,630,000	7,310,000	8,940,000	6,648,000	—	180,000	12,268,000
Fund balances (deficit)							
Unrestricted							
Designated for long-term investment	3,800,000	—	3,800,000	—	—	—	3,800,000
Undesignated	1,290,000	(900,000)	390,000	—	—	—	390,000
	5,090,000	(900,000)	4,190,000	—	—	—	4,190,000
Restricted	—	—	—	—	$1,320,000	—	1,320,000
Net investment in plant	—	—	—	38,900,000	—	—	38,900,000
Total fund balances (deficit)	5,090,000	(900,000)	4,190,000	38,900,000	1,320,000	—	44,410,000
Total liabilities and fund balances	$6,720,000	$6,410,000	$13,130,000	$45,548,000	$1,320,000	$180,000	$56,678,000

*Interfund borrowings eliminated in combination.

EXHIBIT 9B

Sample Religious Organization

Statement of Support and Revenue, Expenses, Capital Additions, and Changes in Fund Balances

Year Ended December 31, 19X1

	Expendable Funds						
	Operating					*Nonex-pendable*	
	Unrestricted	*Restricted*	*Deposit and Loan*	*Total*	*Plant Fund*	*Endow-ment Funds*	*Total All Funds*
Support and revenue							
Contributions and bequests	$ 6,800,000	$180,000	—	$ 6,980,000	—	—	$ 6,980,000
Fees for services	4,000,000	—	—	4,000,000	—	—	4,000,000
Endowment and other investment income	200,000	40,000	—	240,000	—	—	240,000
Net gain on investment transactions	250,000	—	—	250,000	—	—	250,000
Contributed services	950,000	—	—	950,000	—	—	950,000
Auxiliary activities	205,000	—	$535,000	740,000	—	—	740,000
Total support and revenue	12,405,000	220,000	535,000	13,160,000	—	—	13,160,000
Expenses							
Program services							
Pastoral	3,300,000	45,000	—	3,345,000	$ 300,000	—	3,645,000
Education	4,000,000	80,000	—	4,080,000	460,000	—	4,540,000
Health care	2,800,000	25,000	—	2,825,000	250,000	—	3,075,000
Social services	900,000	50,000	—	950,000	85,000	—	1,035,000
Cemeteries	220,000	20,000	—	240,000	20,000	—	260,000
Religious personnel development	600,000	—	—	600,000	55,000	—	655,000
Auxiliary activities	160,000	—	685,000	845,000	5,000	—	850,000
Total program services	11,980,000	220,000	685,000	12,885,000	1,175,000	—	14,060,000

Supporting services							
General administration	180,000	—	—	180,000	15,000	—	195,000
Fund raising	120,000	—	—	120,000	10,000	—	130,000
Total supporting services	300,000	—	—	300,000	25,000	—	325,000
Total expenses	12,280,000	220,000	685,000	13,185,000	1,200,000	—	14,385,000
Excess (deficiency) of support and revenue over expenses before capital additions	125,000	—	(150,000)	(25,000)	(1,200,000)	—	(1,225,000)
Capital additions							
Contributions and bequests	—	—	—	—	310,000	$ 200,000	510,000
Investment income	—	—	—	—	15,000	—	15,000
Net gain on investment transactions	—	—	—	—	—	80,000	80,000
Total capital additions	—	—	—	—	325,000	280,000	605,000
Excess (deficiency) of support and revenue over expenses after capital additions	125,000	—	(150,000)	(25,000)	(875,000)	280,000	(620,000)
Fund balances (deficit) at beginning of year	5,315,000	—	(750,000)	4,565,000	39,425,000	1,040,000	45,030,000
Transfers to plant funds for plant acquisitions and principal debt service payments financed from operating funds	(350,000)	—	—	(350,000)	350,000	—	—
Fund balances (deficit) at end of year	$ 5,090,000	—	$(900,000)	$4,190,000	$38,900,000	$1,320,000	$44,410,000

EXHIBIT 9C

Sample Religious Organization

Statement of Changes in Financial Position

Year Ended December 31, 19X1

	Expendable Funds				*Nonexpendable Funds*		
	Operating	*Deposit and Loan*	*Total*	*Plant Fund*	*Endowment*	*Annuity and Life Income*	*Total All Funds*
Resources provided							
Excess (deficiency) of support and revenue over expenses before capital additions	$ 125,000	$(150,000)	$ (25,000)	$(1,200,000)	—	—	$(1,225,000)
Capital additions							
Contributions and bequests	—	—	—	310,000	$200,000	—	510,000
Investment income	—	—	—	15,000	—	—	15,000
Net gain on investment transactions	—	—	—	—	80,000	—	80,000
Excess (deficiency) of support and revenue over expenses after capital additions	125,000	(150,000)	(25,000)	(875,000)	280,000	—	(620,000)
Items that do not use (provide) resources							
Provision for depreciation	—	—	—	1,200,000	—	—	1,200,000
Net gain on investment transactions	(250,000)	(15,000)	(265,000)	—	(80,000)	$(12,000)	(357,000)
Issuance of long-term debt	—	—	—	400,000	—	—	400,000
Increase in deferred amounts	650,000	—	650,000	3,000	—	2,000	655,000
Proceeds from sale of investments	1,800,000	210,000	2,010,000	332,000	590,000	49,000	2,981,000
Total resources provided	2,325,000	45,000	2,370,000	1,060,000	790,000	39,000	4,259,000

Resources used							
Purchases of building and equipment	—	—	—	755,000	—	—	755,000
Reduction of long-term debt	—	—	—	320,000	—	—	320,000
Purchases of investments	1,830,000	70,000	1,900,000	—	784,000	36,000	2,720,000
Increase in accounts and pledges receivable	400,000	—	400,000	5,000	—	—	405,000
Increase in loans receivable	—	45,000	45,000	—	—	—	45,000
Decrease in accounts payable and accrued expenses	70,000	—	70,000	10,000	—	2,000	82,000
Decrease in deposits payable	—	10,000	10,000	—	—	—	10,000
Total resources used	2,300,000	125,000	2,425,000	1,090,000	784,000	38,000	4,337,000
Transfers to plant funds for plant acquisitions and principal debt service payments financed from operating funds	(350,000)	—	(350,000)	350,000	—	—	—
Increase (decrease) in cash	$ (325,000)	$ (80,000)	$ (405,000)	$ 320,000	$ 6,000	$ 1,000	$ (78,000)

EXHIBIT 9D

Sample Religious Organization

Notes to Financial Statements*

December 31, 19X1

Note 1—Summary of Significant Accounting Policies

(In addition to the policy disclosures illustrated in Note 1 of exhibit 1, the following are typical of additional disclosures to be considered for this type of organization.)

Basis of Presentation

The accompanying financial statements include the assets, liabilities, fund balances, and financial activities of all institutions and organizations providing services at the level of administration above the individual congregation. All significant balances and transactions among the organizations included in the financial statements have been eliminated.

Other Matters

Support arising from contributed services of certain religious personnel has been recognized in the accompanying financial statements. The computation of the value of the contribution of those services represents the difference between the stipends and other amounts paid to or on behalf of the religious personnel and the comparable compensation that would be paid to lay persons if lay persons were to occupy those positions. No computation is made for positions that can be held only by religious personnel.

Note 2—Investments

Note 3—Plant Assets and Depreciation

Note 4—Long-Term Debt

Note 5—Pension Plans

Note 6—Changes in Deferred Restricted Amounts

Note 7—Functional Allocation of Expenses

Note 8—Commitment

The organization has a lease for certain office facilities that expires December 31, 19X9. The lease contains operating expense and real estate tax escalation clauses. The minimum rental commitment on the lease as of December 31, 19X1, aggregates approximately $210,000 with annual payments ranging from $25,000 to $35,000. Rent expense for the year ended December 31, 19X1, amounted to $28,000.

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* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

.138 **EXHIBIT 10—RESEARCH AND SCIENTIFIC ORGANIZATION**

EXHIBIT 10A

Sample Research and Scientific Organization

Balance Sheet

June 30, 19X1, and 19X0

Assets	*19X1*	*19X0*
Current assets		
Cash	$ 125,000	$ 115,000
Certificates of deposit	200,000	210,000
Accounts receivable	372,000	346,000
Unbilled contract revenues and reimbursable grant expenses	488,000	390,000
Prepaid expenses and other current assets	40,000	38,000
Total current assets	1,225,000	1,099,000
Property, plant, and equipment (Notes 1 and 4)		
Land and building	220,000	220,000
Furniture and equipment	167,000	156,000
Leased property under capital leases	479,000	479,000
	866,000	855,000
Less—accumulated depreciation and amortization	259,000	185,000
	607,000	670,000
	$1,832,000	$1,769,000

Liabilities and Fund Balance	*19X1*	*19X0*
Current liabilities		
Accounts payable and accrued expenses	$ 418,000	$ 388,000
Restricted grant advances (Note 2)	261,000	210,000
Obligations under capital leases (Note 4)	88,000	82,000
Total current liabilities	767,000	680,000
Noncurrent capital lease obligations (Note 4)	309,000	397,000
	1,076,000	1,077,000
Fund balance		
Unrestricted	458,000	419,000
Net equity in fixed assets	298,000	273,000
Total fund balance	756,000	692,000
	$1,832,000	$1,769,000

EXHIBIT 10B

Sample Research and Scientific Organization

Statement of Revenues, Expenses, and Changes in Fund Balance

Years Ended June 30, 19X1, and 19X0

	19X1	*19X0*
Revenues (Notes 1, 2, and 3)		
Contract revenues—U.S. government	$ 5,958,000	$5,578,000
Restricted grants—foundations and individuals	4,752,000	4,172,000
Other, including interest	43,000	41,000
	10,753,000	9,791,000
Expenses		
Research and development		
Environmental	5,263,000	4,997,000
Health	2,992,000	2,766,000
National defense	1,166,000	938,000
Management and general	1,103,000	985,000
Contract and grant procurement	165,000	151,000
	10,689,000	9,837,000
Excess (deficiency) of revenues over expenses	64,000	(46,000)
Fund balance, beginning of year	692,000	738,000
Fund balance, end of year	$ 756,000	$ 692,000

EXHIBIT 10C

Sample Research and Scientific Organization

Statement of Changes in Financial Position

Years Ended June 30, 19X1, and 19X0

	19X1	*19X0*
Financial resources were provided by		
Excess (deficiency) of revenues over expenses	$ 64,000	$ (46,000)
Add—expenses not requiring current outlay of working capital—depreciation and amortization	74,000	26,000
Working capital provided by (used in) operations	138,000	(20,000)
Financing of fixed asset additions through capital leases	—	397,000
Total resources provided	138,000	377,000
Financial resources were used for		
Acquisition of property, plant, and equipment	11,000	481,000
Reduction of noncurrent capital lease obligations	88,000	—
Total resources used	99,000	481,000
Increase (decrease) in working capital	$ 39,000	$(104,000)
Changes in working capital were represented by		
Increase (decrease) in current assets—		
Cash	$ 10,000	$ (14,000)
Certificates of deposit	(10,000)	(40,000)
Accounts receivable	26,000	10,000
Unbilled contract revenues and reimbursable grant expenses	98,000	42,000
Other	2,000	(1,000)
	126,000	(3,000)
(Increase) decrease in current liabilities—		
Accounts payable and accrued expenses	(30,000)	(23,000)
Restricted grant advances	(51,000)	4,000
Obligations under capital leases	(6,000)	(82,000)
	(87,000)	(101,000)
Increase (decrease) in working capital	$ 39,000	$(104,000)

EXHIBIT 10D

Sample Research and Scientific Organization

Notes to Financial Statements*

June 30, 19X1, and 19X0

Note 1—Summary of Significant Accounting Policies

(In addition to the policy disclosures illustrated in Note 1 of exhibit 1, the following are typical of additional disclosures to be considered for this type of organization.)

Revenue Recognition

Substantially all of the organization's revenue is derived from restricted grants and cost-plus-fixed-fee contracts. Revenue is recognized based on the proportion of project expenses incurred to total anticipated project expenses (percentage-of-completion method). Losses on contracts are recognized when identified.

Note 2—Restricted Grants

Note 3—Government Contracts

Certain contract costs billed to the U.S. government are subject to audit by the Defense Contract Audit Agency. The agency has audited costs billed before July 1, 19X0.

Note 4—Lease Commitments

The organization uses data processing equipment under capital leases expiring in 19X7 which provide for the transfer of ownership of the equipment at the end of the lease term. The related future minimum lease payments as of June 30, 19X1, are as follows:

19X2	$ 94,000
19X3	94,000
19X4	94,000
19X5	94,000
19X6	94,000
19X7	10,000
	480,000
Less—amount representing interest	(83,000)
Present value of minimum lease payments	$397,000

Note 5—Functional Allocation of Expenses

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

.139 EXHIBIT 11—TRADE ASSOCIATION

EXHIBIT 11A

Sample Trade Association

Balance Sheet

June 30, 19X1, and 19X0

	19X1	*19X0*
Assets		
Current assets		
Cash	$ 15,000	$ 24,000
Marketable securities, at market (Note 2)	433,000	330,000
Accounts receivable, net of allowance for doubtful accounts of $6,000 in 19X1 and $8,000 in 19X0	51,000	67,000
Publications inventory, at lower of cost (FIFO) or market	122,000	80,000
Total current assets	621,000	501,000
Long-term investments, at market (Note 2)	240,000	250,000
Fixed assets, at cost, net of accumulated depreciation of $45,000 in 19X1 and $26,000 in 19X0 (Note 1)	66,000	60,000
Other assets	56,000	46,000
Total assets	$983,000	$857,000
Liabilities and Fund Balance		
Current liabilities		
Accounts payable and accrued expenses	$ 96,000	$ 41,000
Deferred membership dues (Note 1)	262,000	245,000
Total current liabilities	358,000	286,000
Fund balance	625,000	571,000
Total liabilities and fund balance	$933,000	$857,000

EXHIBIT 11B

Sample Trade Association

Statement of Revenue, Expenses, and Changes in Fund Balance

Years Ended June 30, 19X1, and 19X0

	19X1	*19X0*
Revenue		
Membership dues (Note 1)	$ 369,000	$ 279,000
Conferences and meetings	642,000	601,000
Publication sales and advertising	285,000	275,000
Special assessments	101,000	95,000
Investment income including net gains on investments	21,000	23,000
Total revenue	1,418,000	1,273,000
Expenses (Note 5)		
Member services	113,000	109,000
Conferences and meetings	335,000	334,000
Technical services	437,000	472,000
Communications, including publication of magazine	122,000	72,000
Total program expenses	1,007,000	987,000
General administration	308,000	219,000
Membership development	49,000	38,000
Total expenses	1,364,000	1,244,000
Excess of revenue over expenses	54,000	29,000
Fund balance, beginning of year	571,000	542,000
Fund balance, end of year	$ 625,000	$ 571,000

EXHIBIT 11C

Sample Trade Association

Statement of Changes in Financial Position

Years Ended June 30, 19X1, and 19X0

	19X1	*19X0*
Funds were provided by		
Excess of revenue over expenses	$ 54,000	$29,000
Add item not requiring funds—depreciation	19,000	12,000
Funds provided by operations	73,000	41,000
Sale of long-term investments	10,000	—
Total funds provided	83,000	41,000
Funds were used for		
Purchase of fixed assets	(25,000)	—
Increase in other assets	(10,000)	(25,000)
Total funds used	(35,000)	(25,000)
Increase in working capital	$ 48,000	$16,000
Analysis of changes in working capital		
Increase (decrease) in current assets		
Cash	$ (9,000)	$17,000
Marketable securities	103,000	21,000
Accounts receivable	(16,000)	(8,000)
Publications inventory	42,000	16,000
	120,000	46,000
Decrease (increase) in current liabilities		
Accounts payable and accrued expenses	(55,000)	(17,000)
Deferred membership dues	(17,000)	(13,000)
	(72,000)	(30,000)
	$ 48,000	$16,000

EXHIBIT 11D

Sample Trade Association

Notes to Financial Statements*

June 30, 19X1, and 19X0

Note 1—Summary of Significant Accounting Policies

Note 2—Investments

Note 3—Pension Plan

Note 4—Lease Agreements/Commitments

Note 5—Functional Allocation of Expenses

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

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EXHIBIT 12—UNION

EXHIBIT 12A

Sample Union

Balance Sheet

December 31, 19X1

(With Comparative Totals for 19X0)

Assets	*General Fund (Undesignated)*	*Strike Insurance Fund (Designated)*	*December 31, 19X1 Total*	*December 31, 19X0 Total*
Current assets				
Cash (including savings accounts of $2,100,000 and $1,050,000) (Note 3)	$ 650,800	$ 1,710,000	$ 2,360,800	$ 1,238,100
Investments at market	491,800	9,054,200	9,546,000	9,640,400
Per capita dues receivable	51,800	133,200	185,000	189,500
Accrued interest receivable	1,800	210,700	212,500	214,600
Loans to affiliated organizations (Note 4)	21,400	—	21,400	27,300
Accounts receivable (less allowance for doubtful accounts of $2,300 and $2,500)	67,900	—	67,900	68,900
Prepaid expenses	74,900	—	74,900	71,500
Total current assets	1,360,400	11,108,100	12,468,500	11,450,300

Property, furniture, and equipment at cost (Note 1)				
Land	678,400	—	678,400	678,400
Buildings (net of accumulated depreciation of $743,500 and $675,600)	1,973,400	—	1,973,400	1,515,500
Furniture and equipment (net of accumulated depreciation of $314,800 and $278,200)	50,800	—	50,800	87,400
Total property, furniture, and equipment	2,702,600	—	2,702,600	2,281,300
Total assets	$4,063,000	$11,108,100	$15,171,100	$13,731,600
Liabilities and Fund Balances				
Current liabilities				
Accounts payable	$ 337,600	—	$ 337,600	$ 423,100
Notes payable	13,100	—	13,100	19,600
Affiliation dues payable	48,800	—	48,800	49,600
Accrued salaries	31,500	—	31,500	33,000
Payroll taxes and employee deductions payable	89,300	—	89,300	90,400
Total current liabilities	520,300	—	520,300	615,700
Fund balances	3,542,700	$11,108,100	14,650,800	13,115,900
Total liabilities and fund balances	$4,063,000	$11,108,100	$15,171,100	$13,731,600

EXHIBIT 12B

Sample Union

Statement of Revenue, Expense, and Changes in Fund Balances
Year Ended December 31, 19X1
(With Comparative Totals for 19X0)

	General Fund (Undesignated)	*Strike Insurance Fund (Designated)*	*December 31, 19X1 Total*	*December 31, 19X0 Total*
Revenue				
Per capita dues (Note 2)	$9,385,500	$ 3,532,300	$12,917,800	$13,219,800
Initiation fees	24,100	—	24,100	22,800
Sales of organizational supplies	26,700	—	26,700	17,900
Rental income	216,300	—	216,300	216,100
Administrative fees—apprentice training	11,800	—	11,800	12,100
Interest income	28,100	609,000	637,100	644,100
Total revenue	9,692,500	4,141,300	13,833,800	14,132,800

Expense (Note 6)				
Program services				
Strike assistance to local unions	877,900	2,630,500	3,508,400	3,345,600
Constitutional convention	154,600	—	154,600	132,800
Field office services				
Organization	2,054,000	—	2,054,000	2,106,500
Negotiation	2,156,700	—	2,156,700	2,212,000
Grievance	924,300	—	924,300	947,900
Total program services	6,167,500	2,630,500	8,798,000	8,744,800
Administrative and general	3,537,700	57,600	3,595,300	1,425,200
Net (gains) losses on investments	(94,400)	—	(94,400)	2,062,800
Total expense	9,610,800	2,688,100	12,298,900	12,232,800
Excess of revenue over expense	81,700	1,453,200	1,534,900	1,900,000
Fund balances, beginning of year	3,461,000	9,654,900	13,115,900	11,215,900
Fund balances, end of year	$3,542,700	$11,108,100	$14,650,800	$13,115,900

EXHIBIT 12C

Sample Union

Statement of Changes in Financial Position
Year Ended December 31, 19X1
(With Comparative Totals for 19X0)

	General Fund (Undesignated)	*Strike Insurance Fund (Designated)*	*December 31, 19X1 Total*	*December 31, 19X0 Total*
Sources of working capital				
Excess of revenue over expense	$ 81,700	$1,453,200	$1,534,900	$1,900,000
Add charges not affecting working capital				
Depreciation	104,500	—	104,500	100,300
Working capital provided	186,200	1,453,200	1,639,400	2,000,300
Use of working capital				
Purchase of property, furniture, and equipment	525,800	—	525,800	352,000
Increase (decrease) in working capital	$(339,600)	$1,453,200	$1,113,600	$1,648,300

Changes in working capital				
Increase (decrease) in current assets				
Cash	$(413,900)	$1,536,600	$1,122,700	$ 186,300
Investments	(15,900)	(78,500)	(94,400)	1,425,200
Per capita dues receivable	(1,300)	(3,200)	(4,500)	(2,300)
Accrued interest receivable	(400)	(1,700)	(2,100)	(1,200)
Loans to affiliated organizations	(5,900)	—	(5,900)	(2,600)
Accounts receivable	(1,000)	—	(1,000)	(100)
Prepaid expenses	3,400	—	3,400	2,900
	(435,000)	1,453,200	1,018,200	1,608,200
Increase (decrease) in current liabilities				
Accounts payable	(85,500)	—	(85,500)	(32,200)
Notes payable	(6,500)	—	(6,500)	(6,500)
Affiliation dues payable	(800)	—	(800)	(200)
Accrued salaries	(1,500)	—	(1,500)	(800)
Payroll taxes and employee deductions payable	(1,100)	—	(1,100)	(400)
	(95,400)	—	(95,400)	(40,100)
Increase (decrease) in working capital	$(339,600)	$1,453,200	$1,113,600	$1,648,300

EXHIBIT 12D

Sample Union

Notes to Financial Statements*

December 31, 19X1, and 19X0

Note 1—Summary of Significant Accounting Policies

Note 2—Strike Insurance Fund

In accordance with the provisions of the Union Constitution, 27 percent of the per capita dues paid to the Union are designated for the Strike Insurance Fund. The fund may be distributed for strike relief at the discretion of the Union Executive Board. No charges may be made against the fund for administrative expenses.

Note 3—Pledged Assets and Contingent Liabilities

The Union is contingently liable as guarantor of a loan of $15,000 to an affiliated local. In connection with the guarantee, a savings account, having a balance of $20,000, is pledged as collateral for the loan.

Note 4—Loans to Affiliated Organizations

The loans to affiliated organizations represent short-term loans to local unions at current interest rates. All such loans are expected to be collected within one year.

Note 5—Pension Plan

Note 6—Functional Allocation of Expenses

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* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

.141 EXHIBIT 13—ZOOLOGICAL AND BOTANICAL SOCIETY

EXHIBIT 13A

Sample Zoological and Botanical Society

Balance Sheet

December 31, 19X1

	Operating Funds	*Plant Fund*	*Endowment Funds*	*Total All Funds*
Assets				
Cash	$ 257,000	$ 20,000	$ 50,000	$ 327,000
Accounts receivable, less allowance for doubtful receivables of $18,000	125,000	—	—	125,000
Pledges receivable, less allowance for doubtful pledges of $95,000	520,000	120,000	—	640,000
Inventories, at lower of cost (FIFO) or market	330,000	—	—	330,000
Investments (Note 2)	7,800,000	3,000,000	2,800,000	13,600,000
Land, buildings, and equipment, at cost or fair value at date of gift, less accumulated depreciation of $10,500,000 (Note 3)	—	23,000,000	—	23,000,000
Other assets	180,000	—	—	180,000
Collections (Note 9)	—	—	—	—
Total assets	$9,212,000	$26,140,000	$2,850,000	$38,202,000
Liabilities and Fund Balances				
Accounts payable and accrued expenses	$ 350,000	$ 225,000	—	$ 575,000
Deferred amounts (Note 6)				
Unrestricted	50,000	—	—	50,000
Restricted	1,600,000	2,915,000	—	4,515,000
Long-term debt (Note 4)	—	900,000	—	900,000
Total liabilities	2,000,000	4,040,000	—	6,040,000
Fund balances				
Unrestricted				
Designated by the governing board for long-term investment	6,200,000	—	—	6,200,000
Undesignated	1,012,000	—	—	1,012,000
	7,212,000	—	—	7,212,000
Restricted—nonexpendable	—	—	$2,850,000	2,850,000
Net investment in plant	—	22,100,000	—	22,100,000
Total fund balances	7,212,000	22,100,000	2,850,000	32,162,000
Total liabilities and fund balances	$9,212,000	$26,140,000	$2,850,000	$38,202,000

EXHIBIT 13B

Sample Zoological and Botanical Society

Statement of Support and Revenue, Expenses, Capital Additions, and Changes in Fund Balances

Year Ended December 31, 19X1

	Operating Funds			*Plant*	*Endowment*	*Total*
	Unrestricted	*Restricted*	*Total*	*Funds*	*Funds*	*All Funds*
Support and revenue						
Contributions and bequests	$ 550,000	$1,045,000	$1,595,000	—	—	$ 1,595,000
Fees and grants from governmental agencies	—	1,200,000	1,200,000	—	—	1,200,000
Admission charges	1,300,000	—	1,300,000	—	—	1,300,000
Membership dues	350,000	—	350,000	—	—	350,000
Endowment and other investment income	420,000	90,000	510,000	—	—	510,000
Net gain realized on investments	180,000	15,000	195,000	—	—	195,000
Auxiliary activities	3,000,000	—	3,000,000	—	—	3,000,000
Total support and revenue	5,800,000	2,350,000	8,150,000	—	—	8,150,000
Expenses						
Program services						
Animal collections and exhibits	2,742,000	1,825,000	4,567,000	$ 440,000	—	5,007,000
Educational activities	350,000	135,000	485,000	42,000	—	527,000
Conservation and public service	60,000	90,000	150,000	14,000	—	164,000
Research activities	220,000	300,000	520,000	50,000	—	570,000
Membership activities	78,000	—	78,000	6,000	—	84,000
Auxiliary activities	1,800,000	—	1,800,000	216,000	—	2,016,000
Total program services	5,250,000	2,350,000	7,600,000	768,000	—	8,368,000

Supporting services						
General administration	530,000	—	530,000	24,000	—	554,000
Fund raising	80,000	—	80,000	8,000	—	88,000
Total supporting services	610,000	—	610,000	32,000	—	642,000
Total expenses	5,860,000	2,350,000	8,210,000	800,000	—	9,010,000
Excess (deficiency) of support and revenue over expenses before capital additions	(60,000)	—	(60,000)	(800,000)	—	(860,000)
Capital additions						
Contributions and bequests	—	—	—	1,030,000	$ 20,000	1,050,000
Investment income	—	—	—	150,000	—	150,000
Net gain realized on investments	—	—	—	100,000	110,000	210,000
Total capital additions	—	—	—	1,280,000	130,000	1,410,000
Excess (deficiency) of support and revenue over expenses after capital additions	(60,000)	—	(60,000)	480,000	130,000	550,000
Fund balances at beginning of year	7,428,000	—	7,428,000	21,384,000	2,800,000	31,612,000
Transfers						
Equipment acquisitions and principal debt service payments	(236,000)	—	(236,000)	236,000	—	—
Realized gains on endowment funds utilized	80,000	—	80,000	—	(80,000)	—
Fund balances at end of year	$7,212,000	—	$7,212,000	$22,100,000	$2,850,000	$32,162,000

EXHIBIT 13C

Sample Zoological and Botanical Society

Statement of Changes in Financial Position

Year Ended December 31, 19X1

	Operating Funds	*Plant Fund*	*Endowment Funds*	*Total All Funds*
Resources provided				
Excess (deficiency) of support and revenue over expenses before capital additions	$ (60,000)	$ (800,000)	—	$ (860,000)
Capital additions				
Contributions and bequests	—	1,030,000	$ 20,000	1,050,000
Investment income	—	150,000	—	150,000
Net gain realized on investments	—	100,000	110,000	210,000
Excess (deficiency) of support and revenue over expenses after capital additions	(60,000)	480,000	130,000	550,000
Items that do not use (provide) resources				
Provision for depreciation	—	800,000	—	800,000
Net gain realized on investments	(195,000)	(100,000)	(110,000)	(405,000)
Issuance of long-term debt	—	900,000	—	900,000
Increase in deferred amounts	200,000	350,000	—	550,000
Proceeds from sales of investments	3,200,000	1,270,000	900,000	5,370,000
Total resources provided	3,145,000	3,700,000	920,000	7,765,000
Resources used				
Purchases of building and equipment	—	1,480,000	—	1,480,000
Reduction of long-term debt	—	36,000	—	36,000
Purchases of investments	2,861,000	2,372,000	848,000	6,081,000
Increase in accounts and pledges receivable	80,000	30,000	—	110,000
Increase in inventories	8,000	—	—	8,000
Decrease in accounts payable and accrued expenses	10,000	20,000	—	30,000
Total resources used	2,959,000	3,938,000	848,000	7,745,000
Transfers				
Equipment acquisitions and principal debt service payments	(236,000)	236,000	—	—
Realized gains on endowment funds utilized	80,000	—	(80,000)	—
Total transfers	(156,000)	236,000	(80,000)	—
Increase (decrease) in cash	$ 30,000	$ (2,000)	$ (8,000)	$ 20,000

EXHIBIT 13D

Sample Zoological and Botanical Society

Notes to Financial Statements*

December 31, 19X1

Note 1—Summary of Significant Accounting Policies

Note 2—Investments

Note 3—Plant Assets and Depreciation

Note 4—Long-Term Debt

Note 5—Pension Plan

Note 6—Changes in Deferred Restricted Amounts

Note 7—Functional Allocation of Expenses

Note 8—Commitments

Note 9—Collections

The note should disclose the following:

a. Capitalization basis or a statement that collections are not capitalized.

b. Policy on accounting for current year's purchased and donated collections.

c. The nature and the cost, or contributed value, of current year accessions and the nature of and proceeds from deaccessions.

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

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Section 10,260

Statement of Position 79-1
Accounting for Municipal Bond Funds

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Section 10,260

Statement of Position 79-1
Accounting for Municipal Bond Funds

January 15, 1979

[Proposal to the Financial Accounting Standards Board to Amend AICPA Industry Audit Guide, *Audits of Investment Companies*]

NOTE

The American Institute of Certified Public Accountants has issued a series of industry-oriented audit guides that present recommendations on auditing procedures and auditors' reports and, in some instances, on accounting principles, and a series of accounting guides that present recommendations on accounting principles. Based on experience in the application of these guides, AICPA subcommittees or task forces may from time to time conclude that it is desirable to change a guide. A statement of position is used to revise or clarify certain of the recommendations in the guide to which it relates. A statement of position represents the considered judgment of the responsible AICPA subcommittee or task force.

To the extent that a statement of position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the audit guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the subcommittee or task force.

To the extent that a statement of position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the subcommittee or task force are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the subcommittee or task force believes would be in the public interest.

.01 The AICPA Industry Audit Guide (audit guide), *Audits of Investment Companies,* as amended, notes that "changes in the rules, regulations, practices, and procedures of the investment company industry have been frequent and extensive in recent years" and that "further changes are under consideration." A recent development in the investment company industry is the municipal bond fund (or tax-exempt bond fund) in corporate form made possible by the Tax Reform Act of 1976. For the first time, the law allows an investment company organized in corporate form to distribute tax-free income to its shareholders. Before the 1976 Reform Act, two forms of investment companies that specialized in municipal bonds were unit investment trusts and limited partnerships.

.02 A tax-exempt municipal bond fund is an investment company that invests principally in municipal bonds. It may be in the form of a management investment company or a unit investment trust. Municipal bonds are obligations of local governments (such as state, county, and city), and the interest paid on those bonds is exempt from federal income tax. The interest on certain of those bonds may also be exempt from state and local income tax.

.03 This proposed addition to the audit guide presents the committee's views on accounting and reporting matters and other considerations relating to municipal bond funds. While the discussion of taxes and distribution policies refers specifically to municipal bond funds in corporate form, the discussion of valuation and other matters applies to municipal bond funds in corporate form, partnership form, and unit investment trusts.

DEFINITION OF AND MARKET FOR MUNICIPAL BONDS AND NOTES

Municipal Bonds

.04 Municipal bonds are usually issued to obtain funds for a variety of public purposes, including the construction of a wide range of public facilities such as airports, bridges, highways, housing, hospitals, mass transportation, schools, streets, and water and sewer works. Municipal bonds may also be issued to refund outstanding obligations, obtain funds for general operating expenses, and obtain funds to lend to other public institutions and facilities.

.05 Industrial development bonds are issued by or on behalf of public authorities to obtain funds to finance privately operated industrial or commercial facilities. These obligations may be classified as municipal bonds, provided that the interest paid on them is exempt from federal income tax.[1]

.06 The two principal classifications of municipal bonds are general obligation bonds and revenue bonds. General obligation bonds represent the issuer's unqualified pledge, based on its faith, credit, and taxing power, to pay principal and interest when due. Revenue bonds are payable from the revenues derived from a particular class of facilities or from other specific revenue sources. Tax-exempt industrial development bonds are usually revenue bonds and generally do not carry the pledge of the credit of the issuer.

[1] See Internal Revenue Code, section 103.

.07 The yields on municipal bonds depend on a variety of factors, including market conditions, maturity date, and ratings assigned to the issue.

Municipal Notes

.08 Municipal notes generally mature in less than three years. They are usually designated as tax, revenue, or bond anticipation notes because they are redeemable on receipt of anticipated taxes or revenue or on refinancing from the proceeds of municipal bonds. They include short-term tax-exempt project notes issued by public housing or urban renewal agencies of local communities, with payment of principal and interest guaranteed by the United States government.

Market

.09 There are estimated to be more than 40,000 issuers and well over one million issues of municipal bonds, counting each maturity as a separate issue. The bonds are traded in a dealer market in which little published price information exists. As a result, new issues of municipal bonds are usually sold by competitive bids. Subsequent market quotations for municipal bonds may be obtained from dealers in those securities. If there is little trading activity or if a thin market exists, dealer quotations may not indicate the prices at which a municipal bond may be bought or sold.

PORTFOLIO INVESTMENTS

Valuation

.10 In considering the values assigned to municipal bonds, the fund and its auditor should follow the direction given in the audit guide for the valuation of over-the-counter securities:

> A company may adopt a policy of using a mean of the bid prices, or of the bid and asked prices, or of the prices of a representative selection of broker/dealers quoting on a particular security; or it may use a valuation within the range of bid and asked prices considered best to represent value in the circumstances. Any one of these policies is considered to be acceptable if *consistently* applied. . . .
>
> Ordinarily, quotations for an over-the-counter security should be obtained from more than one broker/dealer unless available from an established market-maker for that security, and quotations for several days should be reviewed. In all cases, the quotations should be from *unaffiliated persons*. . . .

> Where quotations appear questionable, consideration should be given to valuing the security at "fair value as determined in good faith by the board of directors" [emphasis added].[2]

.11 In addition, the auditor is provided with the following guidance:

> In the case of over-the-counter securities for which quotations were not available from published sources, the auditor should consider obtaining quotations as of the valuation date from *more than one independent source*. . . . If the auditor is not fully satisfied with valuation date results, he may wish to obtain further quotations at a subsequent date or dates or consider having the security valued by the board of directors [emphasis added].[3]

Determining Market Value

.12 A fund may obtain quoted bid and asked prices directly from dealers. If possible, the fund should obtain prices from a dealer who maintains a market for the issue. If this is not possible, quotations should be obtained from more than one dealer. The portfolio should be valued consistently, using either the bid price or the mean between bid and asked prices as described in the fund's prospectus.

.13 A number of funds have engaged bond dealers or other pricing services to value their portfolios for a fee. This service includes obtaining daily quotations from various dealers and selecting those quotations considered to be most indicative of the market value of the issue. A pricing service may but need not be an expert appraiser of municipal bonds, but it must be able to identify those dealers who are market-makers for an issue and in a position to determine value.

.14 The fund's management is responsible for determining values of portfolio securities in accordance with the fund's policies. Accordingly, if an agent is used for this purpose, the fund must be satisfied that control procedures, whether maintained by the fund or by the pricing service, provide reasonable assurance that material pricing errors would be prevented or detected. Such control procedures might include:

- Checks employed by the pricing service in obtaining daily quotations.
- Verifying daily changes of individual securities prices in excess of a stipulated percentage.

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[2] *Audits of Investment Companies* (New York: AICPA, 1977), pp. 34-35.
[3] *Audits of Investment Companies*, pp. 46-47.

• Verifying dealer quotations with other dealers on a test basis.

.15 In evaluating internal accounting controls, the auditor might consider obtaining independent quotations from dealers or visiting the pricing service's facilities to review the procedures used in obtaining daily quotations, or both. If the auditor considers the internal accounting control to be weak, he should expand the scope of his work as he deems necessary.

Fair Value and Matrix Pricing Methods

.16 Municipal bonds for which market quotations are not readily available or for which the fund believes market quotations may not be indicative of the market value of the issue should be valued at fair value. Fair value is determined by the board of directors of a management investment company. Fair value is determined by the sponsor or trustee of a unit investment trust, and/or other party having such responsibility under the trust agreement. For those determinations, matrix pricing or pricing based on reliable quotations of similar securities may be used. In determining fair value, SEC accounting series releases on the subject, especially ASRs 113 and 118, should be considered.

.17 The auditor should also consult these accounting series releases as well as the audit guide for guidance on reporting on financial statements where a material portion of the securities are valued "in good faith." However, the auditor will usually find that he is able to satisfy himself that the range of possible values of municipal bonds for which reliable quotations are not readily available would not have a significant effect on the fairness of presentation of the financial statements in conformity with generally accepted accounting principles; in which case, he could express an unqualified opinion.

.18 A mathematical technique known as matrix pricing uses market data available for the issue and similar issues without exclusive reliance on quoted market prices in determining securities valuations.[4] This method, when used by a fund, results in a "fair value" determination. Accordingly, the auditor's pro-

[4] Matrix pricing uses electronic data processing techniques to determine valuations for normal institutional-size trading units of debt securities without exclusive reliance on quoted prices. The use of data processing techniques enables one to consider factors such as the issue's coupon interest rate, maturity, and rating by a service and those of similar issues for which quoted prices are available to develop a calculation of what the current market yields would be for the issue in question. Those techniques may also consider market indexes and other market data.

cedures for examining value determined by using matrix pricing should be the same as those applied with respect to any other fair values, as discussed in paragraphs .12 through .17, above.

"When Issued" Securities

.19 Municipal bond funds buy securities on a "when issued" basis more often than most other types of funds. A municipal securities underwriter solicits expressions of interest in a proposed issue and sends a "when issued" priced confirmation against which delivery is made at a later date when the terms of the issue are known. The securities will normally begin trading on a "when issued" basis at the time such confirmation is issued and begin trading as if they had been issued a few days before the closing date. For federal income tax purposes, the holding period of the securities does not begin until they are issued.[5]

.20 While securities offerings have been aborted after "when issued" trading begins, these situations are rare. The asset and liability relating to a "when issued" security should be recorded when the priced transaction confirmation is issued, and the investment should be valued thereafter. Because the securities do not earn interest until the settlement date, they should be identified in the financial statements. The same accounting methods should be used for securities purchased under a delayed delivery contract under which the managing underwriter agrees to deliver securities to purchasers at later specified dates.

Portfolio Insurance

.21 A number of municipal bond funds, primarily those organized as unit investment trusts with fixed portfolios, arrange for insurance that guarantees the collection of principal and interest when due. The insurance normally applies to portfolio securities only while they are owned by the fund, and its coverage is not transferable to a purchaser of the security. This arrangement differs from those in which the issuer of the securities acquires the insurance, making the insurance feature an element of the security and transferable on changes in ownership. If the insurance applies to the fund's portfolio only, it does not have any measurable value in the absence of default of the underlying securities or indications of the probability of such default.

.22 Probability of default may be indicated if the market value of a bond held by the fund declines significantly and the

[5] I. T. 3721, 1945 C. B. 164, modified by Rev. Rul. 57-29, 1957-1 C. B. 519.

decline appears to be related to the credit worthiness of the issuer. Problems with respect to credit worthiness may be recognized through comparison with market values of similar securities or by a downgrading of credit ratings.

.23 Valuation of bonds that are held in an insured portfolio and that are in default or for which the probability of default is indicated requires a "fair value" determination as described in the audit guide (pages 35-37) and as further discussed in paragraph .16. Among the factors that should be considered in making this "fair value" determination are the terms of the insurance policy, the intention and ability of the fund to hold the bonds until maturity, and the ability of the insurer to perform under the policy in the event of default.

.24 Proceeds of insurance in place of defaulted interest are exempt for federal income tax purposes.[6]

.25 Insured securities that have been valued as provided in paragraph .23 should be identified in the financial statements as being so valued. Disclosure should also be made of the intention of the fund to hold the securities until maturity in order to realize the benefits of the insurance.

Presentation

.26 Municipal securities should be grouped either by state or municipality within the state or by purpose of issue, whichever is more meaningful. This grouping will also satisfy regulation S-X requirements that investments be classified by type of business.

.27 Although not required, bond ratings of the portfolio of investments are often disclosed. If the auditor has not checked the ratings against published sources, they should be identified as unaudited.

.28 The valuation methods used by the fund should be disclosed in the financial statements.

TAX AND OTHER CONSIDERATIONS

Qualification as a Regulated Investment Company

.29 To enjoy the benefits of paying tax-free dividends to shareholders, a municipal bond fund taxable as a corporation

[6] Rev. Rul. 76-78.

must first qualify as a regulated investment company.[7] Because the Internal Revenue Code states that gross income excludes tax-exempt income, such a fund must pay particular attention to meeting requirements in the following respects:[8]

a. Section 851(b)(3) of the code requires that in order to be qualified as a regulated investment company, less than 30 percent of a fund's gross income may be derived from gains (disregarding losses) from the sale or other disposition of securities held for less than three months. Because the amount of taxable income realized by a municipal bond fund is usually a small percentage of its total income, the base used to determine the effect of the three-month test is usually very small. Consequently, a municipal bond fund taxable as a corporation with a small amount of taxable income may lose its right to qualify as a regulated investment company if it realizes any gains from the sale of securities held for less than three months.[9]

b. If a municipal bond fund realizes taxable income, it is usually a relatively small amount. Nevertheless, 90 percent of that amount as well as 90 percent of tax-exempt income must be distributed. Declaring dividends in proportion to taxable and tax-exempt income may prevent an inadvertent under-distribution of taxable income.[10]

.30 Because premiums paid on purchases of obligations of a state, territory, or possession of the United States, or their political subdivisions, must be amortized for federal income tax purposes, most funds have chosen to amortize those premiums for book purposes. Original issue discount on tax-free bonds is generally amortized periodically for book and tax purposes.

.31 Because investment companies carry securities at value, amortization of premium or discount has no effect on net asset value. Amortization of bond premium results in a decrease in interest income with a corresponding increase in unrealized

[7] Tax-exempt unit investment trusts are not generally organized as associations taxable as corporations for federal income tax purposes. Interest exempt from federal income tax retains that status when distributed to unit holders by such trusts.

[8] The tax considerations described herein are as of the date of issuance of this statement of position. The reader should determine whether subsequent changes have been effected in the pertinent provisions of the Internal Revenue Code.

[9] The Revenue Act of 1978 resolved this problem by providing that "gross income" for purposes of the 90 percent and 30 percent tests includes tax-exempt interest. In addition, the act disallows any loss recognized within thirty-one days of the date of purchase of shares in a tax-exempt mutual fund to the extent of any tax-exempt interest dividend received by a shareholder.

[10] See note 9.

appreciation of investments and vice versa for amortization of bond discount. As a result, a policy of amortization may affect net investment income but would not affect total income from investments (net investment income plus realized and unrealized gains and losses). The accounting policy for amortization should be disclosed in the financial statements.

.32 For determining the amortization of premium on tax-exempt securities, the Internal Revenue Service has ruled (Rev. Rul. 60-17) that bond premium in excess of the call price, if any, must first be amortized to the earliest call date and the basis of the bond reduced accordingly. A remaining excess premium over a subsequent call price must be amortized to that subsequent call date. For those purposes, the remaining excess premium at a point in time is the total premium (that is, amount paid in excess of maturity value) reduced by previous amortization to previous call dates. Finally, the portion of the premium equivalent to the difference between the last call price and the maturity value is amortized over the period from the last call date to maturity.

Equalization

.33 Funds that do not declare dividends daily may use equalization accounting, as described in chapter 2 of the audit guide. A municipal bond fund that realizes a significant amount of taxable income (usually interest on investments in short-term securities) should allocate equalization debits and credits between undistributed tax-exempt income and taxable income.

.34 In defining earnings and profits of a municipal bond fund, I. R. C. sec. 852(c) and Treas. Reg. 1.852-5(b) state that "earnings and profits . . . for any taxable year (but not its accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income for such taxable year." The result may be taxation of a distribution of income equalization credits as ordinary income, as illustrated below.

	Book Undistributed Income	Tax Basis Earnings and Profits: Current	Tax Basis Earnings and Profits: Accumulated
Tax-exempt interest income	$100,000	$100,000	$100,000
Expenses	(16,000)[1]		(16,000)
Income equalization credits (net)	12,000		
Balance	96,000	100,000	84,000
Dividends paid[2]			
Exempt-interest dividends	84,000[3]	84,000	84,000
Ordinary dividends	12,000[4]	12,000	—
Total dividends	96,000	96,000	84,000
Undistributed income at year end	—[5]	$ 4,000	—

[1] Not deductible from current earnings and profits (Treas. Reg. 1.852-5(b)).
[2] Based on the assumption that the fund's policy is to distribute all its net equalization credits.
[3] Exempt-interest dividend = $84,000 ($100,000 − $16,000).
[4] Distribution in excess of exempt-interest dividend may be taxed as ordinary income (Treas. Reg. 1.852-5(b)).
[5] Based on the assumption of a dividend payment on the last day of each month. The undistributed balance of current earnings and profits has no federal income tax significance since the fund has distributed its net tax-exempt income (I. R. C., sec. 852).

Distribution Requirements

.35 The Tax Reform Act of 1976 provides that a regulated investment company that meets certain tests in addition to those enumerated above may pass tax-exempt interest through to its shareholders as "exempt-interest dividends."[11] A dividend qualifies as an exempt-interest dividend only if—

a. At the close of each quarter of its taxable year, at least 50 percent of the value of the total assets of the regulated investment company consists of certain tax-exempt government obligations.

b. The dividend is designated by the regulated investment company as an exempt-interest dividend in a written notice mailed to its shareholders not later than forty-five days after the close of its taxable year.

.36 If a fund is disqualified from treating distributions as exempt-interest dividends, it may still qualify as a regulated investment company if it meets the other applicable tests.

[11] Tax-exempt unit investment trusts are not generally organized as associations taxable as corporations for federal income tax purposes. Interest exempt from federal income tax retains that status when distributed to unit holders by the trusts.

Distribution Policies

.37 Municipal bond funds whose investment policies require that 100 percent of their assets be invested in tax-exempt securities realize only tax-exempt income except for net gains realized on the sale of investments, which are taxable.

.38 In addition to following the requirements prescribed by the code, a municipal bond fund must also consider the tax effect on its shareholders in deciding on its distribution policies. Because gains realized on redemption of capital shares are taxable to the redeeming shareholders, dividends from net investment income are frequently declared daily in order to maximize the amount received by the redeeming shareholder as tax-exempt income. Dividends are usually paid quarterly or monthly, but redeeming shareholders may receive unpaid dividends at the time of redemption.

Allocation of Expenses

.39 The code requires that a municipal bond fund's allowable deductions be allocated between its taxable and tax-exempt income. Capital gains are excluded from this calculation. The only acceptable basis for allocation appears to be the ratio of tax-exempt income to gross investment (tax-exempt plus taxable) income. The required amortization of premium on tax-exempt bonds must be allocated to the tax-exempt income.

TRANSITION

.40 An accounting change to adopt the provisions of this statement of position should be made prospectively. The change should be made in financial statements issued subsequent to the date of this statement of position. Disclosures should be made in the financial statements in the period of change in accordance with paragraph 17 of APB Opinion 20.

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Accounting by Cable Television Companies

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Statement of Position 79-2

Accounting by Cable Television Companies

March 12, 1979

[Proposal to the Financial Accounting Standards Board]

NOTE

Statements of position of the accounting standards division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the accounting standards executive committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, statements of position do not establish standards enforceable under the Institute's code of professional ethics.

INTRODUCTION

.01 Cable television (CATV) companies have developed diverse specialized industry accounting practices over a period of years, with the result that their financial statements lack comparability. This statement of position summarizes CATV companies' current specialized industry accounting practices. A study of those accounting practices by the AICPA Accounting Standards Division indicates a need for clarification and narrowing of alternative accounting practices within the industry.

GENERAL BACKGROUND

.02 Cable television systems receive television signals, which are amplified and distributed to the premises of subscribers, usually over a community-wide coaxial cable distribution network. The signals originate from local and distant television broadcasting stations and are received by the CATV system by means of high antennas, microwave relay, or satellite. CATV systems may also distribute programs that originate in the systems. "Pay cable" service, consisting primarily of uncut and uninterrupted movies and sporting events, has been initiated relatively recently but is already generally available.

.03 CATV systems typically distribute signals of the three national TV networks and, to the extent permitted by Federal Communications Commission regulations, signals of independent and educational TV stations (UHF and VHF) and FM radio stations. The systems generally have a capacity of twelve to twenty TV channels, although some newer systems provide more. Many CATV systems require the attachment of a converter to the subscriber's set.

.04 The copyright law (Public Law 94-553) defines a cable TV system as follows.

> A "cable system" is a facility, located in any state, territory, trust territory, or possession, that in whole or in part receives signals transmitted or programs broadcast by one or more television broadcast stations licensed by the FCC, and makes secondary transmission of such signals or programs by wires, cables, or other communication channels to subscribing members of the public who pay for such services.

.05 The copyright law requires cable systems to pay royalty fees computed on the basis of specified percentages of the gross receipts from subscribers to the cable service for the basic service of secondary transmission.

.06 For operational and accounting purposes, a cable TV system may include one or more communities and may operate under one or more franchises granted by the governing authorities of the city, county, or state served by the system. Franchises are for a stated term and contain various conditions and limitations, which frequently include prescribed maximum service subscription fees, payment of fees to the local government, conditions of service, including provision of a minimum number of channels, and time limitations on specified construction. Failure to comply with the conditions and limitations of a franchise may give the granting authority the right to terminate the franchise and may result in lawsuits for collection of damages.

.07 The cable TV plant required to render service to the subscriber includes the following equipment:

a. *Head-end*—includes the equipment used to receive signals of distant TV or radio stations, whether directly from the airwaves or from a microwave relay system. It also includes the studio facilities required for operator-originated programming, if any.

b. *Cable*—consists of cable (in the past, usually coaxial cable) and amplifiers (which maintain the quality of the signal) covering the subscriber area, either on utility poles or underground.

c. *Drops*—consist of the hardware that provides access to the main cable, the short length of cable that brings the signal from the main cable to the subscriber's TV set, and other associated hardware, which may include a trap to block particular channels.

d. *Converters and descramblers*—devices attached to the subscribers' TV sets when more than twelve channels are provided or when special services are provided, such as "pay cable" or two-way communication.

.08 The construction period of a cable TV system varies with the size of the franchise area, density of population, and difficulty of physical construction. The construction period is not completed until the head-end main cable and distribution cables are installed, and includes a reasonable time to provide for installation of subscriber drops and related hardware. During the construction period many system operators complete installation of drops and begin to provide service to some subscribers in some parts of the system while construction continues. Providing the signal for the first time is referred to as "energizing" the system. The period from the first earned subscriber revenue until the end of this construction period is referred to as the "prematurity period" in subsequent sections of this statement.

Some system operators will construct the better portions of the franchise area and allow the system's operations to develop before extending it, well after the end of the first major construction period, to more marginal areas.

.09 Special circumstances in different franchises will require different planning; the variety of plans would include the following typical franchise development and construction plans:

a. Small franchise, characterized by the absence of free television signal. The construction period is short and the entire system is energized at one time near the end of the construction period.

b. Medium-size franchise, characterized by some direct competition from free television and a more extensive geographical franchise area lending itself to incremental construction, with some parts of the system energized as construction progresses.

c. Large metropolitan franchise, characterized by heavy direct competition from free television and fringe area signal inadequacy, high cost, and difficult construction, with many parts of the system energized as construction progresses.

The length of the prematurity period varies with these circumstances and with the company's construction plan. It might range from less than a month to six months in a small marketing area with under 5,000 homes, one year in a medium-size area of 25,000 to 30,000 homes, or two years or more in a large urban market.

.10 A substantial investment is required to provide for the following costs of a cable TV system:

a. Franchise acquisition costs.

b. Cost of physical facilities (see paragraph .07), including cost of labor for erection, installation, interest on construction in progress, and construction overhead.

c. Costs relating to the cable TV system and signal, such as interest on previously capitalized costs, property taxes, pole rental, and microwave charges, which may be incurred both before and after the first subscriber hookup.

d. Other operating costs (in excess of any revenues) incurred during the construction period and before sufficient subscribers are obtained to achieve break-even operations.

If the franchise requires underground construction, construction costs and investment are substantially increased.

.11 Cable TV operators lease space on telephone or utility poles or in underground ducts. Pole attachment agreements typically have an initial term of one to five years and thereafter are terminable by either party on relatively short notice.

.12 The principal source of cable TV revenue is the monthly subscription fee for primary connections to subscribers. Additional revenues are received (*a*) from subscribers for secondary connections and connection charges, (*b*) from the sale of local advertising or from leasing time on unused channels, and (*c*) from pay cable services.

CURRENT INDUSTRY ACCOUNTING PRACTICES

Cable TV Investment

.13 The cost of materials, labor, and construction overhead is included in the cost of the cable TV plant. Cable TV companies have not uniformly capitalized interest during construction. However, the predominant practice among cable TV companies whose securities are publicly held has been to capitalize interest during construction and to include the capitalized costs in cable TV plant costs. Depreciation of new cable TV plant is usually computed using the straight-line method over periods that vary from ten to fifteen years.

.14 Initial subscriber installation costs, which include the material, labor, and overhead costs of the drop, are capitalized and depreciated over periods similar to or shorter than those used for cable TV plant. The costs of subsequently disconnecting and reconnecting subscribers typically are charged to expense. In addition, some companies have received revenues of the nature of payments in aid of construction from developers and have credited such amounts to the plant account.

.15 Except in the smallest systems, it is usually possible to deliver programming to portions of the system (energize the system) and obtain some revenues before construction of the entire system is complete. Thus, virtually every cable TV system experiences a prematurity period during which it is receiving some revenue while continuing to incur substantial costs related to the establishment of the total system. In general, the larger the city served by the cable TV system, the longer this period will be.

.16 Many different methods are used to account for costs and revenues during this prematurity period, although virtually all companies whose securities are publicly held defer such costs in some manner. Practices followed in accumulating the net costs deferred vary widely. Some companies defer all costs, including general and administrative, before maturity; some companies defer only operating costs; others defer only certain specified costs. Some companies depreciate cable TV plant during this period and others do not. Some reduce the deferred costs by the revenues recorded and others do not. Finally, although deferred costs are subject to a recoverability test, recoverability is measured in different ways.

.17 Accounting conventions for the determination of the maturity date, at which time deferral ceases and amortization of deferred costs begins, vary significantly within the industry. Some companies define maturity on the basis of the time elapsed since energizing the system, which varies from eighteen months to three years; others define maturity in terms of the number of subscribers connected; and still others use break-even operations as maturity. The break-even point is sometimes determined on a cash basis and sometimes on an accrual basis. Some companies use the actual break-even point and others use the originally budgeted break-even point.

.18 Deferred costs are usually amortized on the straight-line method (*a*) over periods of five to ten years or (*b*) over the estimated useful life of the cable TV system.

.19 Some companies separately defer marketing cost during the period before maturity and amortize them over a shorter period, such as three years.

Franchise Costs

.20 The costs of original franchise applications are generally deferred until the franchise has been granted and it is determined that the franchise will be developed. Costs of unsuccessful franchise applications and abandoned franchises are charged to expense. Costs of successful applications are amortized on bases similar to those for purchased franchises (paragraph .22).

.21 Purchased franchises are accounted for in diverse ways. Some companies allocate costs to purchased franchises in proportion to their fair value. Others allocate any excess of acquisition cost over the fair value of tangible and other identifiable intangible assets acquired, less liabilities assumed, to franchises. Some treat the excess as the cost of franchises and goodwill without separate distinction, and others treat the excess as goodwill alone.

.22 Some companies do not amortize the cost of franchises acquired before November 1, 1970. The costs of franchises acquired on or after November 1, 1970, have been amortized, in accordance with APB Opinion 17, over periods of up to forty years. However, periods as short as five to ten years are also used; they are usually related to the remaining franchise term. The straight-line method of amortization is generally used, although other methods can be found in practice. For example, amortization may be based on the ratio of subscribers served in the period to the estimated total number of subscribers to be served in each year during the amortization period.

Hookup Revenue

.23 Companies engage in various marketing activities to obtain subscribers, some of which involve relatively expensive advertising efforts. The amounts charged by cable TV companies to subscribers for hookups vary; sometimes there is a substantial charge, sometimes there is none. Also, the revenues are accounted for in diverse ways. Many companies record them as subscriber revenues; others record them as an offset to marketing costs. In either event, companies believe hookup revenue to be incidental, either because it is often waived as part of a promotional campaign, or because it relates more to the marketing effort involved than to the costs of hooking up new subscribers. During the early stages of system development, companies record hookup revenue as a reduction of deferred costs.

THE DIVISION'S CONCLUSIONS

Accounting During the Prematurity Period of a Cable TV System

.24 The accounting standards division believes that recovery of the investment in a cable TV system (paragraph .10) is usually predictable and, accordingly, that costs incurred during construction before the first subscriber hookup may be capitalized. In addition, since major construction activity normally continues after the first subscriber hookup, a portion of certain costs relating to the cable TV system and signal should usually continue to be capitalized. Furthermore, the division believes that the most theoretically appropriate, systematic, and rational allocation of capitalized plant would result from a computation that attempts to approximate depreciation on the basis of total "subscriber months" over the life of a system. For example, if a system were expected to have an average of 1,000 subscribers over its 180-month depreciation life and had achieved 300 subscribers, current monthly depreciation would be 300/180,000 of the cost of the system.

.25 The following paragraphs contain the division's recommendations for conforming accounting practice within the industry while implementing the general conclusions in paragraph .24 in a practical manner:

Recoverability (paragraph .26).

Prematurity period (paragraph .27).

Cost of physical facilities (paragraph .28).

Period costs (paragraph .29).

Other capitalizable costs (paragraph .30).

Capitalization and depreciation formula (paragraphs .31-.32).

Revenues (paragraph .33).

These recommendations recognize the appropriateness of capitalization of certain costs and of lower than straight-line depreciation during the prematurity period, but, for practical reasons, they do not permit inclusion in the depreciation base of increases in estimated subscribers expected to occur after the prematurity period. Thus, in the example in paragraph .24, average number of subscribers is to be calculated using subscribers expected at the end of the prematurity period for all years after that date.

.26 *Recoverability.* An overriding consideration in reflecting incurred costs as assets is the expectation of recovery. Accordingly, circumstances must indicate that expected revenues from a cable TV system will be sufficient to cover expected operating expenses, including amortization of intangible assets and depreciation of plant. Otherwise, no additional costs should be capitalized, and an evaluation should be made to determine if a write-down to recoverable values (through operations or sale of the system) of intangible assets and previously capitalized plant is indicated.

.27 *Prematurity Period.* Before the first earned subscriber revenue, management must determine a prematurity period for purposes of determining capitalized costs, depreciation, and amortization. This period begins with the first earned subscriber revenue. Its end will vary with circumstances at the system, but will be determined based on the company's plans for completion of its first major construction period (paragraphs .08 and .09) or achievement of a specific predetermined subscriber level at which no additional cash investments will be required for other than physical facilities and interest. Information submitted to the division indicates that there should be a presumption that the period should not be longer than two years, and that it will frequently be shorter. Only in the largest major urban markets could a longer period be reasonably justified. Once determined, the prematurity period should not be changed except under highly unusual circumstances. Inability of management to make a reasonable estimate of the prematurity period is likely to indicate either an extremely short period or uncertainty of recovery. In either case, additional costs should not be capitalized.

.28 *Cost of Physical Facilities.* Nothing in this statement (other than the discussion of lack of recoverability in paragraph .26 and the discussion of interest during construction in paragraphs .34-.35) is intended to suggest that construction costs of physical facilities, including direct labor and construction overhead, should not be capitalized in full during and after the prematurity period.

.29 *Period Costs.* During the prematurity period, subscriber-related costs and selling, marketing, and administrative expenses should be accounted for as period costs and should not be considered for capitalization. Such costs include those relating to existing subscribers such as billing and collection, bad debts, and mailings; costs of repairs and maintenance of taps and connections; franchise fees related to revenues or number of subscribers; general and administrative system costs such as salaries of the system manager and office rent; programming costs for additional channels used in the marketing effort or costs related to revenues from, or number of subscribers to, per channel or per program service; and direct selling costs (paragraph .43).

.30 *Other Capitalizable Costs.* During the prematurity period, the cable TV system is partially under construction and partially servicing current operations. Management must distinguish between costs of physical facilities (paragraph .28), costs attributable solely to current operations and their administration (paragraph .29), and the generally fixed costs relating to the cable TV system and signal, which are attributable to both current and future operations. The last category includes interest (paragraphs .34-.35) on previously capitalized tangible and intangible costs; property taxes based on valuation as a fully operating system; pole, underground duct, antenna site and microwave rental; and local origination programming to satisfy franchise requirements. The division of these costs between costs capitalized and costs expensed should be determined as described in paragraphs .31 and .32.

.31 *Capitalization and Depreciation Formula.* Based on the plans described in paragraph .27, management should estimate the number of subscribers expected during each month of the prematurity period. During the prematurity period, costs attributable to both current and future operations (paragraph .30) should be charged to expense in an amount equal to the fraction of average subscribers expected during each month to total subscribers expected at the end of the prematurity period; only the balance should be capitalized. During the same period, depreciation should be computed as the foregoing fraction applied to monthly depreciation and amortization of total anticipated capitalized costs expected on completion of the prematurity period, using the straight-line or other depreciation method normally applied by the company after the prematurity period.

.32 The division believes that an objective upper limit to the costs capitalized and a lower limit on depreciation charged under the formula in paragraph .31 is necessary to ensure that excessive costs are not capitalized and adequate depreciation is provided. Accordingly, the division believes that the estimated number of subscribers during each month of the prematurity period should reflect, on a cumulative basis, at least equal (that is, straight-line) monthly progress in adding new subscribers toward the estimate at the end of the period. Furthermore, monthly amounts charged to expense should be increased whenever it becomes clear that the actual number of subscribers is increasing at a rate faster than expected.

.33 *Revenues.* During the prematurity period, all revenues except those from hookups (paragraph .43) should be reported as system revenues, and the portion of costs, depreciation, and amortization charged to expense under the formula described in paragraphs .31 and .32 as well as the period costs described in paragraph .29 should be included in appropriate categories of costs of services.

Interest During Construction

.34 In November 1974, the Securities and Exchange Commission issued Accounting Series Release 163, which, broadly speaking, precludes adoption of the practice of capitalizing interest during construction by companies, other than public utilities, registered with the SEC. The Financial Accounting Standards Board is currently considering the matter of accounting for interest costs and any pronouncement issued is expected to be applicable to cable television companies.

.35 The accounting standards division believes that because of FASB's pending consideration of accounting for interest costs, it should state no conclusion at this time on the general subject of interest capitalization. However, companies that do not capitalize interest before energizing should not do so in subsequent periods (paragraphs .24 through .33).

Segmentation

.36 In certain cases, a portion of a cable TV system may be clearly distinguishable from the remainder of the system.[1] Such a portion would have most of the following characteristics:

a. Geographical differences, such as coverage of a noncontiguous or separately awarded franchise area.

b. Mechanical differences, such as a separate head-end.

c. Timing differences, such as starting construction or marketing at a significantly later date.

d. Investment decision differences, such as separate break-even and return-on-investment analyses or separate approval of the start of construction.

e. Accountability differences, such as separate revenue and expense accounts and separate budgets and forecasts.

.37 The division believes that a portion that can be clearly distinguished from the remainder of the system should be accounted for as a separate system. Costs incurred by the remainder of the system should be charged to the portion only if they are specifically identified with the operations of that por-

[1] Some cable television companies have used the word "segment" to refer to a portion of a cable TV system. In view of the use of "segment" in a different context in FASB Statement No. 14, the word "portion" has been used here.

tion. General allocations should not be used for purposes of determining portion prematurity costs that may be capitalized in accordance with the recommendations made elsewhere in this statement. Separate projections for the portion should be developed and the portion's capitalized costs should be evaluated for recoverability separately from the remainder of the system.

Purchased Franchises and Goodwill

.38 When a cable TV system is acquired in a transaction accounted for as a purchase, values should be assigned to franchises and goodwill in accordance with APB Opinion 16 and amortized in accordance with APB Opinion 17. The following examples indicate the types of analysis appropriate for cost allocation and amortization.

a. If a single system is acquired, the values of franchise costs and goodwill ordinarily would not be separable and therefore would be assigned the same life.

b. If a company that operates multiple systems is acquired, the several franchises acquired will have various remaining terms and prospects for renewal, and the franchises may provide for different allowable rates to be charged for the monthly service as well as other different conditions and limitations. The value of an amortization period for each franchise would have to be determined separately. Any excess of the cost of the acquired company over the sum of the amounts assigned to identifiable assets acquired (including individual franchises) less liabilities assumed should be recorded as goodwill related to the entire operation. The amortization period for this goodwill would be determined independently of the various franchise lives.

.39 Intangible assets other than franchises and goodwill may be identified in the purchase of some cable TV systems. For example, values may be ascribed to noncancelable exclusive agreements for sporting events, to subscriber lists, or to a rate below current market for pole rental. Such assets should also be amortized in accordance with the provisions of APB Opinion 17.

Depreciation and Amortization

.40 Since costs incurred to bring a cable system to a fully operational status create a resource with a period of expected benefit not substantially different from the useful life of the physical facilities, the division believes that the amortization period for such costs should be the same as that used to depreciate the main cable TV distribution system.

.41 A number of factors are involved in determining the proper lives for depreciation and amortization purposes. These factors include the legal franchise life, the economic useful life of the main cable television plant, and the accounting life of the main cable television plant. If the accounting life used is longer than the legal franchise life, there should be justification to support the conclusion that the unamortized assets will be recovered at the end of the franchise. Support for such a conclusion would include but not be limited to the ability to recover the net book value on disposal or the likely renewal of the system's franchise; the latter could be either on terms similar to or different from the original franchise. If the terms of a likely franchise renewal are expected to cause a significant diminution in value to the owner of the system, the original franchise life should be used for amortization of other assets.

.42 Once the system is fully operational, it should continue to be reviewed for recoverability as described in paragraph .26.

Hookup Revenue

.43 The division believes that hookup revenue should be allocated to systems revenue to the extent of direct selling costs, with any balance deferred and taken into income over the estimated average period that subscribers are expected to remain connected to the system.

.44 Direct selling costs include commissions, the portion of salespersons' compensation other than commissions that results in obtaining subscribers, and costs of processing documents relating to new subscribers acquired. They should not include supervisory and administrative expenses or indirect expenses such as rent and facilities costs.

.45 The cost of a subscriber connection made at a location where a previous customer had been connected to the system should be charged to expense unless the cost of the previous connection has been written off.

Programming Material

.46 The costs of programming material produced for internal use or for sale to others should be accounted for in accordance with the provisions of the AICPA Industry Accounting Guide, *Accounting for Motion Picture Films.* Purchased program material should be accounted for in accordance with the recommendations made in the division's Statement of Position 75-5 [section 10,090], *Accounting Practices in the Broadcasting Industry.*

Accounting Principles for Regulated Industries

.47 Some states have adopted legislation that regulates CATV systems as public utilities. Cable TV systems are similar to utilities only in that they require heavy plant investment, service by "connection" for each subscriber, and are subject (in varying degrees) to regulation of subscription rates and levels of service required to maintain their franchise rights. Other aspects of cable TV systems are not similar to public utilities. There has been no identifiable consistency in the application of the rate-making process for cable TV systems; the procedures for setting utility rates, on the other hand, are similar in nature. Finally, since the operator competes with other entertainment industries, service charges sometimes are less than the authorized rates.

.48 The division believes that the addendum to APB Opinion 2 does not apply to the financial statements of cable TV companies.

Financial Statement Presentation

.49 Since a cable TV company generates its revenue through use of its property, plant, and equipment, it has few current assets as that expression is defined in terms of a one-year operating cycle. Therefore, the division believes that it is not necessary to identify current assets and liabilities separately in the financial statements. Debt maturities should be disclosed in the financial statements or related notes.

.50 Costs incurred to bring a cable TV system to a fully operational status that are capitalized under the provisions of paragraphs .24 to .33 should be classified with plant and equipment, but separately identified. Companies with systems under construction or in the prematurity period should disclose amounts capitalized during the reporting period and the ending date of the prematurity period.

Transition

.51 This statement of position should be applied in financial statements for fiscal years beginning after December 15, 1978, although earlier application is encouraged. Accounting changes adopted to apply the recommendations of this statement of position should be made retroactively by restating the financial statements of prior periods.

.52 Companies may not have readily available the forecast information needed to make the required calculations under paragraphs .24-.33. In that event, actual historical subscriber data may be substituted for the forecast information.

.53 Companies that do not expect to have systems in the prematurity period in the future should continue their previous method of accounting for already mature systems, in accordance with APB Opinion 20, paragraph 16. For example, a single locally owned system, the owners of which expect to make no investments in additional cable TV systems, should not change its previous accounting. Systems that are subsidiaries or divisions of multiple system groups, however, should follow the accounting recommended for the group.

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Section 10,280

Statement of Position 79-3 Accounting for Investments of Stock Life Insurance Companies

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Section 10,280

Statement of Position 79-3
Accounting for Investments of Stock Life Insurance Companies

March 23, 1979

[Proposal to the Financial Accounting Standards Board to Amend AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies*]

NOTE

The American Institute of Certified Public Accountants has issued a series of industry-oriented audit guides that present recommendations on auditing procedures and auditors' reports and, in some instances, on accounting principles, and a series of accounting guides that present recommendations on accounting principles. Based on experience in the application of these guides, AICPA committees, subcommittees, or task forces may from time to time conclude that it is desirable to change a guide. A statement of position is used to revise or clarify certain of the recommendations in the guide to which it relates. A statement of position represents the considered judgment of the responsible AICPA committee, subcommittee, or task force.

To the extent that a statement of position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the audit guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the committee, subcommittee, or task force.

To the extent that a statement of position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the committee, subcommittee, or task force are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the committee, subcommittee, or task force believes would be in the public interest.

INTRODUCTION

.01 In 1972, the AICPA Insurance Companies Committee issued the industry audit guide, *Audits of Stock Life Insurance Companies* (referred to in this statement of position as "guide"). Part II of the guide, which discusses the application of generally accepted accounting principles, includes a section (pages 88 through 90) on the "Valuation of Investments and Recognition of Realized and Unrealized Gains (Losses) Thereon." That section outlines five acceptable methods of accounting for gains or losses on the sale of equity securities.

.02 The accounting standards division believes that it is not desirable to have five alternative accounting methods for accounting for equity securities and related investment gains or losses by stock life insurance companies. Therefore, this statement of position expresses the division's conclusions on accounting for all investments and related realized and unrealized gains or losses of stock life insurance companies.[1] This statement of position also expresses the division's conclusions on accounting for real estate by stock life insurance companies, which was not discussed in the guide. This statement of position applies only to stock life insurance companies.

.03 The interests of policyholders and the public in the financial integrity of stock life insurance companies make it important that the solvency of those companies be continuously demonstrated to regulatory authorities. Consideration of those interests, together with the uncertainties inherent in the future, has resulted in the conservative accounting practices prescribed or permitted by insurance regulatory authorities (statutory accounting practices [2]). Federal income taxation of life insurance companies is also based primarily on statutory accounting practices. The use of generally accepted accounting principles, as discussed in this statement of position, should not be construed as an indication that those accounting principles should also be used in reporting to regulatory or taxing authorities.

VALUATION OF INVESTMENTS AND RECOGNITION OF RELATED REALIZED AND UNREALIZED GAINS OR LOSSES

Discussion

.04 Under statutory accounting practices, investments in common stocks are carried at market value, preferred stocks generally are carried at cost, bonds generally are carried at amortized cost, mortgages are generally carried at unpaid principal or amortized cost if purchased at a discount or premium, and real estate generally is carried at depreciated cost. Realized investment gains or losses and changes in the carrying amount

[1] This statement of position supersedes the section in the guide on "Valuation of Investments and Recognition of Realized and Unrealized Gains (Losses) Thereon."

[2] Practices that have been prescribed by statute, regulation, or rule or that have been permitted by specific approval or acceptance.

of investments representing unrealized appreciation or depreciation are credited or charged to stockholders' equity.

.05 The guide states that any of the five following methods of recognizing realized and unrealized investment gains or losses could be used:

a. Include realized gains and losses on investments in determining net income and report unrealized gains or losses as direct increases or decreases in a special stockholders' equity account.

b. Present realized and unrealized gains and losses on equity securities and realized gains and losses on bonds in a separate statement.

c. Include realized and unrealized gains and losses on all investments in unassigned surplus.

d. Present realized and unrealized gains and losses on all investments in a separate statement.

e. For subsidiaries of noninsurance companies, restate investments in equity securities from market to cost for purposes of consolidation and recognize in income the realized gains and losses on sales of securities.

Conclusions

.06 Bonds should be carried at amortized cost if the company has both the ability and intent to hold the bonds until maturity and there is no decline in the market value of the bonds other than a temporary decline. In those rare instances in which a company is a trader in bonds and does not intend to hold the bonds until maturity, the bonds should be carried at market; temporary fluctuations in the market value of the bonds should be recognized as unrealized gains or losses.

.07 Common and nonredeemable preferred stocks should be carried at market. Preferred stocks that by their terms must be redeemed by the issuing company should be carried at amortized cost if the company has both the ability and intention to hold the stocks until redemption and there is no decline in the market value of the stocks other than a temporary decline.

.08 Mortgages should be accounted for at unpaid principal or amortized cost if purchased at a discount or premium unless collectibility is uncertain. Real estate investments should be accounted for at depreciated cost unless there is an impairment in value.[3] Amortization, depreciation, and other related charges or credits should be charged or credited to investment income. Charges and credits to valuation accounts should be included in realized gains and losses.

.09 Realized gains and losses on all assets held for investment (including, but not limited to, stocks, bonds, mortgage loans, real estate, joint ventures, and subsidiaries held for investment) should be included in the statement of income below operating income and net of applicable income taxes. Realized gains and losses on the sale of other assets, such as property used in the business and operating subsidiaries, should be included in the statement of income before applicable income taxes. Unrealized investment gains and losses should be recognized in stockholders' equity net of applicable income taxes and should not be included in net income.

.10 If a decline in the value of an investment in a security below its cost or amortized cost is other than temporary, the investment should be written down to its net realizable value, which becomes the new cost basis. The amount of the writedown should be accounted for as a realized loss. A recovery from the new cost basis should be recognized only at sale, maturity, or other disposition of the asset, as a realized gain.

.11 Valuation accounts should not be used for publicly-traded bonds, common stocks, or preferred stocks.[4]

REAL ESTATE

Discussion

.12 Under statutory accounting practices, real estate is classified as an investment regardless of its use. For real estate used in operations, rent is included in investment income and is charged to the operating departments. The guide is silent on that subject and the statutory accounting practice has gained general acceptance in the industry.

Conclusions

.13 Real estate should be classified either as an investment or as property used in the business, based on its predominant use.

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[3] Investments in leased assets should be accounted for in accordance with FASB Statement No. 13, *Accounting for Leases.*

[4] This paragraph is not intended to preclude the accrual of losses from uncollectible receivables when both conditions in paragraph 8 of FASB Statement No. 5, *Accounting for Contingencies,* are met.

Depreciation and other real estate operating expenses should be classified as investment expenses or operating expenses consistent with the balance sheet classification of the related asset. Imputed investment income and rent expense should not be attributed to real estate used in the business.

TRANSITION

.14 The conclusions in this statement of position should be applied to financial statements of stock life insurance companies issued for annual and interim periods ending after July 1, 1979. Earlier application is encouraged. The conclusions in this statement of position should be applied retroactively and financial statements presented for prior periods should be restated.

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Section 10,290

Statement of Position 79-4
Accounting for Motion Picture Films

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Section 10,290

Statement of Position 79-4
Accounting for Motion Picture Films

March 26, 1979

[Proposal to the Financial Accounting Standards Board to Amend AICPA Industry Accounting Guide *Accounting for Motion Picture Films*]

NOTE

The American Institute of Certified Public Accountants has issued a series of industry-oriented audit guides that present recommendations on auditing procedures and auditors' reports and, in some instances, on accounting principles, and a series of accounting guides that present recommendations on accounting principles. Based on experience in the application of these guides, AICPA committees, subcommittees, or task forces may from time to time conclude that it is desirable to change a guide. A statement of position is used to revise or clarify certain of the recommendations in the guide to which it relates. A statement of position represents the considered judgment of the responsible AICPA committee, subcommittee, or task force.

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To the extent that a statement of position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the committee, subcommittee, or task force are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the committee, subcommittee, or task force believes would be in the public interest.

INTRODUCTION

.01 The AICPA industry accounting guide, *Accounting for Motion Picture Films* (guide), discusses, in addition to other subjects, accounting for revenue from television exhibition, that is, sales of rights to permit one or more exhibitions of a film (including features, series, and specials made for television) during specified license periods. The guide concludes that the revenue from films licensed for television should not be recognized prior to commencement of the license period and not until all of the following conditions have been met:

1. The sales price for each film is known.
2. The cost of each film is known or reasonably determinable.
3. Collectibility of the full license fee is reasonably assured.
4. The film has been accepted by the licensee in accordance with the conditions of the license agreement.
5. The film is available, i. e., the right is deliverable by the licensor and exercisable by the licensee.

The guide further states that

> The fifth condition regarding availability distinguishes the recommended method from the contract method in that revenue is not recognized until the right is exercisable by the licensee and all conflicting licenses have expired. Exhibition rights transferred to a licensee generally are definable by geographic market area and are marketed in a manner to avoid conflict in a given market. Conflict may exist in a market between (1) theaters and television stations, (2) network television and local stations, and (3) two or more local stations within the market area. The conflict between theatrical showing and telecasting also is recognized by the producer (or owner) of the film, who usually imposes restrictions on distribution which prohibit the licensing of the film for television for a sufficient period of time to allow for theatrical release. Because of these circumstances, the Committee has concluded that revenue from licensing of a film should be recognized in the same sequence as the market-by-market exploitation of the film and at the time the licensee is able to exercise his rights under the agreement, which would be the later of the commencement of the license period (the right then being exercisable by the licensee) or the expiration of a conflicting license (the right then being deliverable by the licensor).

.02 It has come to the attention of the division that the description of availability quoted above does not discuss restrictions on the timing of showings other than the first showing of a motion picture film under a license agreement. The effect of those types of restrictions needs to be clarified because different interpretations have developed in practice.

CONCLUSION

.03 The division believes that restrictions on timing of showings other than the first showing should not affect the recognition of revenue when there is no conflicting license preventing usage by the licensee. This conclusion applies to restrictions on timing of subsequent showings of a feature or special and to restrictions on timing of showings of subsequent episodes of television series. This conclusion does not modify the requirement that all the conditions in paragraph .01 should be met before revenue is recognized.

.04 This statement of position amends the guide by inserting the following as the concluding sentences of the description of availability quoted above (second paragraph on page 8 of the guide):

> Thus, the availability condition is met when a film may be shown for the first time under a licensing agreement. The committee has concluded that restrictions on timing of subsequent showings of the film under the same license agreement, or a contemporaneous license with the same licensee, do not affect the availability date.

TRANSITION

.05 This statement of position should be applied to all license agreements with initial availability dates after December 31, 1978.

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Section 10,300

Statement of Position 80-1 Accounting for Title Insurance Companies

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Section 10,300

Statement of Position 80-1 Accounting for Title Insurance Companies

January 31, 1980

[Proposal to the Financial Accounting Standards Board]

> **NOTE**
>
> Statements of position of the accounting standards division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the accounting standards executive committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.
>
> The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, statements of position do not establish standards enforceable under the Institute's code of professional ethics.

.01 The AICPA Insurance Companies Committee has reviewed existing accounting literature dealing with variances between (*a*) generally accepted accounting principles and (*b*) practices prescribed or permitted by insurance regulatory authorities, as those practices relate to title insurance companies, and has identified areas in which further clarification seems necessary. The committee has also identified certain areas that are not covered in present accounting literature.

.02 An exposure draft of a proposed statement of position on *Accounting for Title Insurance Companies* was issued for comment on May 1, 1978, and a public hearing on it was held on July 17, 1978. A second exposure draft was issued on March 16, 1979. Comments received on the exposure drafts and presentations made at the public hearing were considered in preparing this statement of position.

.03 In recent years, accountants, investors, and other users of financial statements have expressed concern over the acceptability of accounting alternatives for similar business transactions. The accounting standards division believes that it is not desirable to have acceptable accounting alternatives in the title insurance industry. Therefore, this statement of position expresses the division's conclusions on acounting methods that should be used in the areas in which accounting alternatives exist.

.04 This statement of position applies to title insurance company financial statements that are intended to present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. In addition, the section on accounting for title plant (paragraphs .25 through .40) applies to financial statements of all entities that use a title plant in their operations. Those entities include, but are not limited to, title insurance companies (underwriters), title abstract companies, and title agents.

.05 The interests of policyholders and the public in the financial integrity of the title insurance industry make it important that the solvency of title insurance companies be demonstrated to regulatory authorities. Consideration of those interests, together with the uncertainties inherent in the future, has resulted in the conservative accounting practices prescribed or permitted by insurance regulatory authorities (statutory accounting practices[1]). Solvency must be continuously demonstrated for a title insurance company to be permitted to offer its services to the public. Federal income taxation of title insurance companies is also based primarily on statutory accounting practices. The use of generally accepted accounting principles, as discussed below, should not be construed as an indication that those accounting principles should also be used in reporting to regulatory or taxing authorities.

PREMIUM REVENUE RECOGNITION

Discussion

.06 The title insurance business primarily involves the issuance of title insurance policies or binders to real estate owners, purchasers, and mortgage lenders, indemnifying them against loss or damage arising out of defects in, or liens on, the title to real estate. Title insurance differs from other traditional prop-

[1] *Statutory accounting practices* are practices that have been prescribed by statute, regulation, or rule, or have been permitted by specific approval or acceptance.

erty and liability insurance in that the term of the policy is indefinite and the premium is not refundable.

.07 While title insurance premiums generally are collected at the time policies are issued or within a reasonable time after issuance, practices vary within the industry regarding when the revenue is recognized as earned.

.08 Under statutory accounting practices, title insurance companies are required to defer a portion of their premium revenue based on statutory formulas, which vary by state. Unearned premiums represent a significant liability in the statutory financial statements of a title insurance company and are recognized as revenue over a relatively long period of time. The statutory method of recognizing revenue is intended to be a conservative means of providing additional protection to policyholders.

.09 Some title insurance companies include the unearned premium reserve as an additional provision for losses in their financial statements that are intended to be presented in conformity with generally accepted accounting principles. Title insurance companies usually do not charge losses against the unearned premium reserve; instead, they establish separate loss reserves for claims that have been reported.

.10 Most title insurance companies recognize the entire premium as revenue at the policy effective date when reporting in conformity with generally accepted accounting principles. The effective date of the policy can be (*a*) the date the real estate sale or loan is closed, (*b*) the date the deed or other instruments are filed, (*c*) the date the policy is issued, or (*d*) the date indicated on the policy as the effective date. Those who support the effective date as the basis for revenue recognition believe that this method produces a proper matching of costs and revenue, since most costs associated with the policy have been incurred by the time the policy becomes effective. Immediate recognition of all revenue is further justified by the fact that there is no cancellation provision or policy term. Those who support immediate recognition of the premium as revenue believe that losses on title insurance policies have occurred by the time the policies are issued and, therefore, loss reserves should be provided concurrent with revenue recognition.

.11 Some companies recognize the premium as revenue at the time a binder is given. In practice, the binder and effective dates can vary from being almost simultaneous to being several months apart, depending on the type of real estate insured (for example, residential, commercial, or construction) and local title search procedures. Those who support the binder date as the point of revenue recognition believe that the title search has been performed as of that date, most related costs have been incurred, and title insurance is in effect. Those who support the effective date rather than the binder date as the basis for revenue recognition believe that the effective date is more conservative than the binder date, since it is not possible to determine at the time a binder is issued whether a policy will ultimately be issued.

.12 A title insurance policy may also be issued by an agent who performs the title search and is authorized to act on behalf of a title insurance company. In those circumstances, the title insurance company may be notified of the issuance of the policy some time after the effective date. It has generally been industry practice to recognize such premium revenue when reported by an agent. Others believe that an estimate should be recorded for such delayed-reported premiums.

Conclusions

.13 Revenue should be recognized as earned when the title insurance company is legally or contractually entitled to collect the premium. In most circumstances, revenue would be recognized on the effective date; however, the binder date would be appropriate if the title insurance company is legally or contractually entitled to collect the premium on the binder date.

.14 If reasonably estimable, revenue and expenses related to policies issued by agents should be recognized when the agents are legally or contractually entitled to collect the premiums, using estimates based on past experience and other sources; if not reasonably estimable, the revenue and expenses should be recognized when agents report the issuance of the policies.

LOSSES

Discussion

.15 Under existing statutory accounting practices, a provision is included in the financial statements for losses that have been reported to the company. However, there is no specific recognition (in the form of loss reserves) in the statutory financial statements for incurred but not reported losses. Statutory accounting practices, however, require that a portion of title insurance premiums received be deferred and taken into income over a number of years. The actual number of years depends on the state in which the policy is written. That practice may be viewed as creating a reserve that is essentially available for losses inasmuch as there are no contractual provisions of the title policy that require the return of any portion of the premium.

.16 Events giving rise to a loss in the title insurance industry for the most part occur before the policy is issued, which contrasts with the typical property and liability loss in which the event giving rise to the loss occurs after the policy is issued. The exceptions to the general rule concerning prior occurrence may arise in certain special types of title coverage, such as mechanics liens coverages in construction projects, in which the events giving rise to losses may occur after the policies are issued.

.17 Industry practice in accounting for title insurance company losses under generally accepted accounting principles varies somewhat, although most companies establish liabilities for all losses on existing policies, including estimates for incurred but not reported losses. The estimates are intended to provide for the ultimate cost of settlement and are based generally on the company's historical experience adjusted for recent developments and trends.

.18 Title insurance companies may sometimes obtain the insured's mortgage, deed of trust, or fee interest in the insured's real estate in connection with the settlement of a claim. The title insurance company's ability to realize a recovery from real estate interests varies substantially as a result of differing circumstances regarding the value of the property and the status of the ownership interest acquired.

Conclusions

.19 Under generally accepted accounting principles, losses should be recognized in the financial statements at the time the related premium revenue is recognized. At that time, a provision should be made for all estimated losses that will result from the issuance of the policies, reduced by estimated recoveries. Unpaid losses, including incurred but not reported losses, should be based on the best estimate of the ultimate cost of settlement, including the effects of inflation and other social and economic factors, reduced by estimated recoveries using past experience adjusted for current trends and any other factors that should modify past experience. Changes in loss estimates resulting from the continuous review process, and differences between estimates and ultimate payments, should be reflected in operations of the period in which the estimates are changed.

.20 Estimated recoveries on unsettled claims, such as a potential ownership interest in real estate, should be evaluated in terms of their estimated realizable value and recorded as a reduction of unpaid losses. The estimated amount of recoveries on settled claims should be reported as an asset.

.21 Property acquired in settling claims should be accounted for at the amount of cash, or its equivalent, expected to be derived from the sale of the property, net of costs such as maintenance and selling expenses required to be incurred prior to sale. Such property should be separately presented in the balance sheet and should not be classified as an investment. Subsequent reductions in the carrying amount and realized gains and losses on the sale of such property should be charged or credited to claims incurred.

.22 No conclusion has been reached on the issue of whether loss reserves should be discounted—that is, whether the time value of money should be considered in determining loss reserves. Because of the importance of that issue, the division believes that it should develop an issues paper on the subject for submission to the Financial Accounting Standards Board. Until the issue is resolved, companies that discount loss reserves or loss adjustment expenses (see paragraphs .23 and .24) should disclose that fact in their financial statements, together with the effects on the financial statements.

LOSS ADJUSTMENT EXPENSES

Discussion

.23 In the course of settling title insurance claims, a title insurance company frequently incurs expenses for outside services (primarily legal) as well as internal settlement expenses. Internal settlement expenses, which are insignificant, generally consist of fixed costs associated with a permanent employee staff handling a variety of functions, including loss adjustment. Practice varies within the industry with respect to recording those expenses. Settlement expenses are accrued by some companies at the time the loss is recognized; settlement expenses are treated by others as period costs.

Conclusions

.24 Internal settlement expenses should be expensed as period costs and external settlement expenses expected to be incurred should be accrued at the time the related losses are accrued.[2]

TITLE PLANT

Discussion

.25 *Nature of Title Plant.* The business of issuing title insurance policies to insure the condition of title to real estate requires the gathering of all public records relating to the properties that, by law, impart constructive notice of their contents. Generally, public records are not indexed or filed according to particular parcels of property, which makes searching records for particular parcels of property a costly, complex, and inefficient process. In view of the time required and costs incurred to examine pertinent public records and abstract (summarize) their contents, title insurance companies construct or purchase an integrated and indexed collection of title records covering all parcels of real estate within a county before they commence business in the county. The title records, referred to in the industry as a title plant, represent the principal productive asset used to generate title insurance revenue.

.26 A title plant consists of (*a*) indexed and catalogued information for a period of time concerning the ownership of, and encumbrances on, real estate, (*b*) information relating to persons having an interest in real property, (*c*) maps, plats, and so forth, (*d*) copies of prior title insurance policies and reports, and (*e*) other documents and records. In summary, a title plant constitutes an historical record of all matters affecting title to parcels of land in a particular geographic area. The number of years covered by a title plant varies, depending on regulatory requirements and management decisions concerning the minimum information period needed to issue title insurance policies efficiently. Title plants are updated on a daily or other frequent basis by the addition of copies of documents on the status of title to specific parcels of real estate.

.27 A title plant, or an ownership interest in a title plant, is obtained either by construction or by purchase. Construction of

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[2] See paragraph .22.

a title plant consists of (*a*) obtaining copies of all historical documents affecting real estate and documents relating to persons having an interest in real estate in a particular county for a specified period of time, (*b*) organizing and summarizing the historical information in an efficient and useful manner, (*c*) designing a system to store and retrieve the information, and (*d*) transcribing the summarized information into the storage and retrieval system. The information obtained can be maintained on a variety of media such as manually-prepared records, machine-prepared records, microfilm, microfiche, or magnetic tape and may be stored in racks, folders, cabinets, or computers. Costs incurred to construct a title plant consist principally of payroll and document copying costs and other costs directly related to title plant construction. Industry practice generally has been to capitalize title plant construction costs until, in the judgment of management, the title plant is operational. A title plant is considered operational at the time it can be used for title searches.

.28 A title plant is composed of (*a*) documents containing historical information relating to real estate in a particular county and (*b*) a system to store and retrieve the information efficiently and effectively. The historical information in a title plant is not consumed by use, is not replaced in the ordinary course of business, and has an indefinite life as long as the information is updated on a current basis. It is often necessary to search records for the earliest recorded documents in order to provide indemnification; in other instances, a title search involves reading information summarized in the most recently issued title report. Accordingly, the economic useful life of the information is indefinite and indeterminable.

.29 *Maintenance of Title Plant.* Maintenance involves the recurring activities required to update a title plant on a daily or other frequent basis. The title plant is updated by adding (*a*) copies of official documents, (*b*) updated reports on the status of title to specific parcels of real estate, and (*c*) records relating to security or other ownership interests. Title insurance companies presently charge maintenance costs to expense as incurred.

.30 Some believe that maintenance costs sustain the value and utility of the title plant but do not add to the asset or result in a new asset. They believe that expensing maintenance costs as incurred is consistent with the industry's general practice of not deferring a portion of the premium and, thus, provides an appropriate matching of costs and revenue. Others believe that maintenance costs add to the value of a title plant and should be capitalized.

.31 *Storage and Retrieval.* Title insurance companies, from time to time, design or acquire new storage and retrieval systems or convert the historical information from one storage and retrieval medium to another (for example, from manually-prepared records to microfilm) in response to new technology, the need to process greater volumes of business, or the need to reduce space required to store historical information. Presently, some title insurance companies identify and capitalize as title plant the costs associated with modernization programs, while others charge the costs to expense as incurred. Some believe that such costs provide economic benefits beyond the accounting periods in which they are incurred, that the storage and retrieval systems have determinable economic useful lives, and that the costs associated with the systems should be capitalized and systematically allocated to operations over their estimated useful lives.

.32 *Sale of Title Plant.* A title insurance company may sell (*a*) all or a portion of a title plant and convey all or an undivided interest in ownership rights to the buyer, (*b*) the right to use all or a portion of a title plant, or (*c*) the right to copy a particular title plant. Accounting practice for those transactions varies. Some companies record the sales proceeds as revenue and do not expense a portion of the cost of the title plant, whereas other companies record the sales proceeds as revenue and expense a portion of the cost of the title plant. Some companies that offset a portion of the cost of the title plant against the sales proceeds present the resulting gain or loss as a separate item in the statement of income. In addition, some companies may consider the entire proceeds from the sale as a return of the cost of the title plant and reduce the cost of the title plant accordingly.

Conclusions

.33 *Nature of Title Plant.* A title plant is a tangible asset that is unique to the title insurance industry. If properly maintained, the historical information in a title plant has an indeterminate life and does not diminish in value with the passage of time.

.34 *Capitalization of Title Plant.* Costs incurred to construct a title plant, including the costs incurred to obtain, organize, and summarize historical information in an efficient and useful manner, should be capitalized until the title plant can be used by the company to conduct title searches and issue title insurance policies. The capitalized costs should be directly related to, and properly identified with, the activities necessary to construct the title plant. After the construction or purchase of a title plant, a company may decide to purchase or construct a title plant (backplant) that antedates the period of time covered by the existing title plant. Costs to construct a backplant must be properly identifiable to qualify for capitalization. Capitalized costs of a title plant should not be depreciated.

.35 Purchased title plants, including a purchased undivided interest in a title plant, should be recorded at cost at the date of acquisition. For a title plant acquired separately, cost should be measured by the fair value of the consideration given.[3] Title plants purchased as part of a group of assets or as part of a business combination accounted for as a purchase should be accounted for in accordance with APB Opinion 16, *Business Combinations.*

.36 *Maintenance of Title Plant.* Costs incurred to maintain a title plant should be expensed as incurred.

.37 *Costs of Title Searches.* Costs incurred to perform title searches should be expensed as incurred.

.38 *Storage and Retrieval.* Costs incurred after a title plant is operational to (*a*) convert the information from one storage and retrieval system to another or (*b*) modify or modernize the storage and retrieval system should not be added to the carrying amount of the title plant; however, such costs may be separately deferred and amortized in a systematic and rational manner.

.39 *Sale of Title Plant.* A title insurance company may (*a*) sell its title plant and relinquish all rights to its future use, (*b*) sell an undivided ownership interest in its title plant, that is, the right to its joint use, or (*c*) sell a copy of its title plant or the right to use it. If the company relinquishes all future rights to its title plant, the amount received as consideration for the sale should be presented as a separate component of revenue, net

[3] Nonmonetary transactions should be accounted for in accordance with APB Opinion 29, *Accounting for Nonmonetary Transactions.*

of the carrying amount of the title plant. If the company sells an undivided interest in its title plant, the amount received as consideration for the sale should be presented as a separate component of revenue, net of a pro rata portion of the carrying amount of the title plant. If the company sells a copy of its title plant or the right to use it, the amount received should be presented as a separate component of revenue. Ordinarily, no cost should be allocated to the sale of a copy or the right to use a title plant. However, if the value of the title plant decreases below its carrying amount as a result of the sale, the carrying amount of the title plant should be written down to its estimated net realizable value.

.40 *Impairments.* Ordinarily, a title plant has an indeterminate life and does not diminish in value with the passage of time; however, the following circumstances may indicate that its value has been impaired:

a. Changes in legal requirements or statutory practices.

b. Effects of obsolescence, demand, and other economic factors.

c. Actions of competitors and others that may affect competitive advantages.

d. Failure to update (maintain) the title plant properly on a current basis.

e. Abandonment of a title plant or other circumstances that indicate obsolescence.

If the value of a title plant decreases below its carrying amount as a result of one or more of the foregoing or other circumstances, the title plant should be written down to its net realizable value.

VALUATION OF INVESTMENTS AND RECOGNITION OF RELATED REALIZED AND UNREALIZED GAINS OR LOSSES

Discussion

.41 Under statutory accounting practices, investments in common and preferred stocks are carried at market value, bonds generally are carried at amortized cost, mortgages are carried at unpaid principal or amortized cost if purchased at a discount or premium, and real estate generally is carried at depreciated cost. Realized investment gains or losses are credited or charged to income. Changes in the carrying amount of investments representing unrealized appreciation or depreciation are credited or charged to stockholders' equity.

.42 The statutory method of accounting for investments is supported by the following reasoning:

a. Carrying bonds whose value has not been permanently impaired at amortized cost is appropriate since a company that has the ability and intent to hold the investments to maturity will be able to realize face amount. Market values that reflect periodic changes in prevailing interest rates are irrelevant in valuing bonds that are expected to be held to maturity.

b. Carrying common and preferred stocks at market is appropriate because a company has no assurance that it will receive more or less than the current market value.

c. Including realized investment gains and losses in net income is appropriate since it is based on the realization principle. Periodic fluctuations in market value are appropriately recognized in valuing equity investments but should not be included in net income because the fluctuations do not meet the realization principle.

.43 Some believe that realized and unrealized investment gains or losses should be combined in a separate financial statement. They believe that valuation of investments under the statutory method is appropriate for the reasons stated above. However, they advocate that changes in the value of investments, whether realized or unrealized, should be presented in a separate financial statement as one combined amount. They believe that this treatment is the most meaningful since the realization of a gain or loss has an offsetting effect on the related unrealized gain or loss. Because of the materiality of the amounts and the significant fluctuations that occur, they believe that realized and unrealized gains or losses should not be included in the determination of net income because that would make net income meaningless.

.44 Some believe that realized gains and losses should be reported as an integral part of a title insurance company's results of operations because an investor's appraisal of a title insurance company's performance should include the results of realized gains and losses over a period of years.

.45 FASB Statement No. 12, *Accounting for Certain Marketable Securities,* discusses the accounting treatment to be followed by specialized industries, such as title insurance companies, with respect to investments in common and preferred stocks.

Conclusions

.46 Bonds should be carried at amortized cost if the company has both the ability and intent to hold the bonds until maturity and there is no decline in the market value of the bonds other than a temporary decline. In those rare instances in which a company is a trader in bonds and does not intend to hold the bonds until maturity, the bonds should be carried at market; temporary fluctuations in the market value of such bonds should be recognized as unrealized gains or losses.

.47 Common and nonredeemable preferred stocks should be carried at market. Preferred stocks that by their terms must be redeemed by the issuing company should be carried at amortized cost if the company has both the ability and intention to hold the stocks until redemption and there is no decline in the market value of the stocks other than a temporary decline.

.48 Mortgages should be accounted for at unpaid principal or amortized cost if purchased at a discount or premium unless collectibility is uncertain. Real estate investments should be accounted for at depreciated cost unless there is an impairment in value.[4] Amortization, depreciation, and other related charges or credits should be charged or credited to investment income. Charges and credits to valuation accounts should be included in realized gains and losses.

.49 Realized gains and losses on all assets held for investment (including, but not limited to, stocks, bonds, mortgage loans, real estate, joint ventures, and subsidiaries held for investment) should be included in the statement of income, below operating income and net of applicable income taxes. Realized gains and losses on the sale of other assets, such as property used in the business and operating subsidiaries, should be included in the statement of income before applicable income taxes. Unrealized investment gains and losses should be recognized in stockholders' equity net of applicable income taxes and should not be included in net income.

[4] Investments in leased assets should be accounted for in accordance with FASB Statement No. 13, *Accounting for Leases.*

.50 If a decline in the value of an investment in a security below its cost or amortized cost is other than temporary, the investment should be written down to its net realizable value, which becomes the new cost basis. The amount of the write-down should be accounted for as a realized loss. A recovery from the new cost basis should be recognized as a realized gain only at sale, maturity, or other disposition of the asset.

.51 Valuation accounts should not be used for common stocks, preferred stocks, or publicly traded bonds.[5]

REAL ESTATE

Discussion

.52 Under statutory accounting practices, real estate is classified as an investment regardless of its use. For real estate used in operations, rent is included in investment income and is charged to the operating departments.

Conclusions

.53 Real estate should be classified either as an investment or as property used in the business, based on its predominant use. Depreciation and other real estate operating expenses should be classified as investment expenses or operating expenses consistent with the balance sheet classification of the related asset. Imputed investment income and rent expense should not be attributed to real estate used in the business. (Property acquired in settling claims should be accounted for as discussed in paragraph .21.)

TRANSITION

.54 The conclusions in this statement of position should be applied to financial statements for fiscal years beginning after December 31, 1980. Earlier application, however, is encouraged. An accounting change to adopt the provisions of this statement of position should be made retroactively by restating the financial statements of prior periods. If information for restatement of prior periods is not available, financial statements and summaries for prior periods presented should be restated for as many consecutive periods preceding the transition date of this statement as is practicable, and the cumulative effect of applying its provisions on the retained earnings at the beginning of

[5] This paragraph is not intended to preclude the accrual of losses from uncollectible receivables when both conditions in paragraph 8 of FASB Statement no. 5, *Accounting for Contingencies*, are met.

the earliest period restated (or at the beginning of the period in which the statement is first applied if it is not practicable to restate any prior periods) should be included in determining net income of that period (see paragraph 20 of APB Opinion 20, *Accounting Changes*). Disclosures should be made in the financial statements in the period of change in accordance with paragraph 28 of APB Opinion 20.

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Section 10,310

Statement of Position 80-2 Accounting and Financial Reporting by Governmental Units

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Section 10,310

Statement of Position 80-2
Accounting and Financial Reporting by Governmental Units

June 30, 1980

[Amendment to AICPA Industry Audit Guide *Audits of State and Local Governmental Units.*]

NOTE

The American Institute of Certified Public Accountants has issued an industry audit guide, *Audits of State and Local Governmental Units* (1974), that presents recommendations on auditing procedures and auditors' reports and on accounting principles. This statement of position has been prepared to revise or clarify certain of the recommendations in that guide. This statement of position represents the considered judgment of the AICPA Committee on State and Local Government Accounting.

To the extent that this statement of position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the 1974 guide. With regard to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the committee.

To the extent that this statement of position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the committee are subject to ultimate disposition by the body responsible for setting standards for financial accounting and reporting by state and local governmental units.

Background

.01 The 1974 AICPA industry audit guide, *Audits of State and Local Governmental Units,* acknowledged *Governmental Accounting, Auditing, and Financial Reporting* (GAAFR), a 1968 publication of the National Committee on Governmental Accounting (NCGA), as an authoritative source in the area of accounting for state and local governmental units. The guide (p. 9) states, "GAAFR's principles do not represent a complete and separate body of accounting principles, but rather are a part of the whole body of generally accepted accounting principles which deal specifically with governmental units. Except as modified in this guide, they constitute generally accepted accounting principles."

.02 In March 1979 the NCGA (now known as the National Council on Governmental Accounting) published a document entitled *Governmental Accounting and Financial Reporting Principles* (Statement 1). That document specifies that the basic general purpose financial statements of the governmental unit as a whole are combined financial statements by fund types and account groups rather than financial statements of individual funds and account groups. It also updates, clarifies, amplifies, and reorders other portions of GAAFR. Since the guide recognizes GAAFR, it is necessary to amend the guide to recognize Statement 1 as an authoritative modification of GAAFR.[1]

Recommendation

.03 The AICPA Committee on State and Local Government Accounting recommends that *Audits of State and Local Governmental Units* be amended throughout to refer to Statement 1 rather than GAAFR. Accordingly, financial statements presented in accordance with Statement 1 are in conformity with generally accepted accounting principles. The following paragraphs amplify that conclusion and explain its implementation with respect to the auditor's standard report.

.04 The following are the basic general purpose financial statements (GPFS) for a state or local governmental unit:

a. Combined balance sheet: all fund types and account groups.

b. Combined statement of revenues, expenditures, and changes in fund balances: all governmental fund types.

c. Combined statement of revenues, expenditures, and changes in fund balances—budget and actual: general and special revenue fund types (and similar governmental fund types for which annual budgets have been legally adopted).

d. Combined statement of revenues, expenses, and changes in retained earnings (or equity): all proprietary fund types.

e. Combined statement of changes in financial position: all proprietary fund types.

f. Notes to the financial statements.

[1] NCGA Statement 2, *Grant, Entitlement, and Shared Revenue Accounting and Reporting by State and Local Governments,* was also issued in March 1979 and is consistent with the AICPA industry audit guide.

(Trust fund operations may be reported in statements *b, d,* and *e* as appropriate, or separately.)

These financial statements, referred to collectively as the combined financial statements, are discussed and illustrated in Statement 1.

.05 Accounting and reporting of encumbrances should follow the approach recommended in Statement 1: Encumbrances outstanding at year-end should not be reported as expenditures or liabilities. The budgetary comparison statement (paragraph .04 *c*), however, should present comparisons of the legally adopted budget with actual data on the budgetary basis, which may include encumbrances or other differences from generally accepted accounting principles.

.06 The type of report that the auditor can issue depends on the financial statements that a governmental unit presents and on the scope of the examination. The combined financial statements listed in paragraph .04 are required for conformity with generally accepted accounting principles, and the auditor should report on those statements, as discussed in paragraph .07. In addition to the combined financial statements, a governmental unit may also issue combining, individual fund, and account group financial statements and supporting schedules, most likely for inclusion in a comprehensive annual financial report, as described in Statement 1 (pp. 19-20). The auditor's reports on such presentations are described in paragraphs .08 and .09. Paragraphs .10 through .13 describe the auditor's reports to be used if governmental units present other types of financial statements.

.07 If the auditor is engaged to examine the combined financial statements and the governmental unit presents only combined financial statements, the auditor should express an opinion on the financial position of the governmental unit, the results of its operations, and the changes in financial position of its proprietary fund types (see Appendix A). In these circumstances, because Statement 1 requires fund accounting (p. 2) and disclosures related to individual funds and account groups (pp. 5, 6, and 24), the scope of the auditor's examination of the combined financial statements ordinarily would include application of auditing procedures related to individual fund and account group financial data.

.08 If the auditor is engaged to examine the combined financial statements and the governmental unit also presents combining, individual fund, and account group financial statements and supporting schedules, the auditor should follow the guidance in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents.* Accordingly, the auditor's report should state whether the combining, individual fund, and account group financial statements and supporting schedules are stated fairly in all material respects in relation to the combined financial statements taken as a whole (see Appendix B), and the auditor should be satisfied that the combining, individual fund, and account group financial statements and supporting schedules are suitably titled. As explained in paragraph .07, the scope of the auditor's examination of the combined financial statements ordinarily would include application of auditing procedures to individual fund and account group data, and the auditor would be in a position to express such an opinion.

.09 If the auditor is engaged to examine both the combined financial statements and the combining, individual fund, and account group financial statements, his opinion should include both presentations. Ordinarily, in such circumstances the auditor will need to expand the auditing procedures that would otherwise be applied to the combining, individual fund, and account group financial statements. If supporting schedules accompany these financial statements, the auditor's report should state whether the information in the schedules is stated fairly in all material respects in relation to the financial statements taken as a whole (see Appendix C) or should disclaim an opinion on that information.

.10 If financial statements for fund types, funds, or account groups that should be included in the combined financial statements (such as the general fixed assets account group or an enterprise fund) are omitted, the auditor should consider the need to express a qualified opinion (see Appendix D) or an adverse opinion because of departure from generally accepted accounting principles (see SAS No. 2, paragraphs 15 through 17). The auditor's report should include an explanatory paragraph that either describes the omitted fund types, funds, or account groups or, preferably, refers to a note that describes those matters.

.11 If all material individual funds and account groups are presented but the governmental unit does not present combined financial statements, the auditor should express an adverse opinion on the financial position of the governmental unit, the results of its operations, and the changes in financial position of its proprietary fund types. However, the auditor may also express an unqualified opinion on the individual fund and account group financial statements (see Appendix E).

.12 The auditor may be engaged to examine financial statements of only a specified enterprise fund and may express an opinion on whether those financial statements are prepared in conformity with generally accepted accounting principles (see Appendix F). A similar report would also be appropriate for a fund of another type (except for the general fund) or an account group. If the financial statements of only the general fund are presented, the auditor should follow the guidance in paragraph .13.

.13 If an auditor is engaged to examine the financial statements of the general fund or the financial statements of more than one fund or account group that are not intended to present fairly the financial position of the governmental unit taken as a whole, results of its operations, or changes in financial position of its proprietary fund types in conformity with generally accepted accounting principles, the auditor's report should be in the form indicated in Appendix F and should include a middle paragraph such as the following:

> As described more fully in Note ___, the financial statements presented are only for the funds and account groups referred to above and are not intended to present fairly the financial position of the City of Example, Any State, at December 31, 19X2, or the results of its operations and the changes in the financial position of its proprietary fund types for the year then ended, in conformity with generally accepted accounting principles.

.14 Combined financial statements of fund types and account groups may have a "total" column that aggregates the columnar statements by fund type and account group. If a total column is shown, it should be captioned "Memorandum Only" because the total column on a combined financial statement is not comparable to a consolidation. A note to the financial statements should disclose the nature of the column and should explain that it does not present consolidated financial information.

.15 The provisions of this statement of position should be adopted for years ending on or after July 1, 1980. Early adoption is encouraged. If these recommendations are adopted early, conformity with principles in Statement 1 should be disclosed.

.16 Statement 1 (p. 26) states, "Adjustments resulting from a change to comply with these principles should be treated as adjustments of prior periods, and financial statements presented for the periods affected should be restated." Thus, accounting changes for governmental funds that are required to comply with Statement 1 principles—such as accrual of property taxes, a change in reporting encumbrances, or presentation of financial statements of a different reporting entity (such as a fund not previously included in the financial statements)—should be reported by restatement of the financial statements for all prior periods presented. The auditor should refer to SAS no. 1, section 546, for guidance on reporting on a change in accounting principle. Statement 1 does not change proprietary fund accounting principles.

APPENDIX A

.17 Auditor's Report: Unqualified Opinion on Combined Financial Statements

We have examined the combined financial statements of the City of Example, Any State, as of and for the year ended December 31, 19X2, as listed in the table of contents. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the combined financial statements referred to above present fairly the financial position of the City of Example, Any State, at December 31, 19X2, and the results of its operations and the changes in financial position of its proprietary fund types for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

APPENDIX B

.18 Auditor's Report: Unqualified Opinion on Combined Financial Statements Presented With Combining, Individual Fund, and Account Group Financial Statements and Supporting Schedules

We have examined the combined financial statements of the City of Example, Any State, as of and for the year ended December 31, 19X2, as listed in the table of contents. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the combined financial statements referred to above present fairly the financial position of the City of Example, Any State, at December 31, 19X2, and the results of its operations and the changes in financial position of its proprietary fund types for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Our examination was made for the purpose of forming an opinion on the combined financial statements taken as a whole. The combining, individual fund, and account group financial statements and schedules listed in the table of contents are presented for purposes of additional analysis and are not a required part of the combined financial statements of the City of Example, Any State. The information has been subjected to the auditing procedures applied in the examination of the combined financial statements and, in our opinion, is fairly stated in all material respects in relation to the combined financial statements taken as a whole.

APPENDIX C

.19 Auditor's Report: Unqualified Opinion on Combined Financial Statements and Combining, Individual Fund, and Account Group Financial Statements Presented With Supporting Schedules

We have examined the combined financial statements of the City of Example, Any State, and the combining, individual fund, and account group financial statements of the city as of and for the year ended December 31, 19X2, as listed in the table of contents. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the combined financial statements referred to above present fairly the financial position of the City of Example, Any State, at

December 31, 19X2, and the results of its operations and the changes in financial position of its proprietary fund types for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. Also, in our opinion, the combining, individual fund, and account group financial statements referred to above present fairly the financial position of the individual funds and account groups of the City of Example, Any State, at December 31, 19X2, and the results of operations of such funds and the changes in financial position of individual proprietary funds for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Our examination was made for the purpose of forming an opinion on the combined financial statements taken as a whole and on the combining, individual fund, and account group financial statements. The accompanying financial information listed as supporting schedules in the table of contents is presented for purposes of additional analysis and is not a required part of the combined financial statements of the City of Example, Any State. The information has been subjected to the auditing procedures applied in the examination of the combined, combining, individual fund, and account group financial statements and, in our opinion, is fairly stated in all material respects in relation to the combined financial statements taken as a whole.

APPENDIX D

.20 Auditor's Report: Qualified Opinion on Combined Financial Statements (One or More Fund Types, Funds, or Account Group Financial Statements Omitted)

We have examined the combined financial statements of the City of Example, Any State, as of and for the year ended December 31, 19X2, as listed in the table of contents. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As described more fully in Note ____, the combined financial statements referred to above do not include financial statements of the [identify fund types, funds, or account groups omitted], which should be included to conform with generally accepted accounting principles.

In our opinion, except that the omission of the financial statements described above results in an incomplete presentation, as explained in the preceding paragraph, the combined financial statements referred to above present fairly the financial position of the City of Example, Any State, at December 31, 19X2, and the results of its operations and the changes in financial position of its proprietary fund types for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

APPENDIX E

.21 Auditor's Report: Adverse Opinion (Omission of Combined Financial Statements) With an Unqualified Opinion on the Individual Fund and Account Group Financial Statements

We have examined the financial statements of the individual funds and account groups of the City of Example, Any State, as of and for the year ended December 31, 19X2, as listed in the table of contents. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The city has not prepared combined financial statements that show the financial position of the City of Example, Any State, at December 31, 19X2, and the results of its operations and the changes in financial position of its proprietary fund types for the year then ended, as required by generally accepted accounting principles. Thus, in our opinion, the financial statements listed in the table of contents do not present fairly the financial position of the City of Example, Any State, at December 31, 19X2, or the results of its operations and the changes in financial position of its proprietary fund types for the year then ended, in conformity with generally accepted accounting principles.

In our opinion, however, the financial statements listed in the table of contents present fairly the financial position of the individual funds and account groups of the City of Example, Any State, at December 31, 19X2, and the results of operations of such funds and the changes in financial position of individual proprietary funds for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

APPENDIX F

.22 Auditor's Report: Unqualified Opinion on an Enterprise Fund's Financial Statements

We have examined the financial statements of the [identify enterprise fund] of the City of Example, Any State, as of and for the year ended December 31, 19X2, as listed in the table of contents. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of the [identify enterprise fund] of the City of Example, Any State, at December 31, 19X2, and the results of its operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Accounting Standards Division

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Section 10,320

Statement of Position 80-3 Accounting for Real Estate Acquisition, Development, and Construction Costs

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Section 10,320

Statement of Position 80-3
Accounting for Real Estate Acquisition, Development, and Construction Costs

December 22, 1980

[Proposal to the Financial Accounting Standards Board]

NOTE

Statements of position of the accounting standards division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the accounting standards executive committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, statements of position do not establish standards enforceable under the Institute's code of professional ethics.

Introduction

.01 Recent trends in real estate development activities have dramatically increased the size of enterprises engaged in real estate development, the cost of individual projects, and the time required to complete the development of individual projects. Those trends have focused attention on the need for guidance in accounting for costs associated with real estate acquisition, development, and construction. The accounting standards division of the American Institute of Certified Public Accountants has prepared this statement of position in response to that need.

Scope of the Statement

.02 Except as indicated in paragraph .03, the recommendations in this statement apply to accounting for real estate acquisition, development, and construction costs in financial statements that are intended to present financial position, results of operations, or changes in financial position in conformity with generally accepted accounting principles, regardless of the nature of the entity involved. The division believes that, in providing guidance, it is desirable to reduce, to the extent practicable, alternative practices in accounting for costs of real estate acquisition, development, and construction.

.03 This statement does not apply to

a. Real estate developed by an enterprise for use in its own operations (excluding sale or rental). In this context, "real estate developed by an enterprise for use in its own operation" includes real estate developed by a member of a consolidated group for use in the operations of another member of the group (for example, a manufacturing facility developed by a subsidiary for use in its parent's operations) when the property is reported in the group's consolidated financial statements. However, such property is not "real estate developed for use in the enterprise's operations" when reported in the separate financial statements of the entity that developed it.

b. Retail lots sold on a volume basis with down payments that are less than those required to evaluate the collectibility of casual real estate sales. The AICPA industry accounting guide, *Accounting for Retail Land Sales*, applies to accounting for lots sold on that basis.

c. Costs and operations covered by the AICPA statement of position [section 10,180], *Accounting for Costs to Sell and Rent, and Initial Rental Operations of, Real Estate Projects.*

.04 Because of the nature of the issues discussed in this statement, and because of the variety of enterprises whose transactions are covered by this statement, the division emphasizes that the provisions of this statement, like the provisions of all statements on accounting principles, need not be applied to items that would have an immaterial effect on an enterprise's financial position or results of operations; also, methods other than those recommended may be used if their use yields results not materially different from the results of applying the recommended methods.

Definitions

.05 For purposes of this statement, the following terms are defined:

a. *Common costs.* Costs that relate to two or more units within a real estate project and thus require allocation to determine the cost of project subdivisions. For example, land cost is usually common to the entire project and must be allocated to phases, tracts, releases, and, ultimately, individual units to determine the cost of sales or the cost of individual units of investment property. Other common costs may relate only to a phase, a tract, or a release and would be allocated only to the parcels to which they relate.

b. *Fair value.* The amount in cash or cash equivalent value of other consideration that a real estate parcel would yield in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. The fair value of a parcel is affected by its physical characteristics, its probable ultimate use, and the time required for the buyer to make use of the property, considering access, development plans, zoning restrictions, and market absorption factors. *Relative fair value* is the fair value of each parcel in a real estate project in relation to the fair value of the other parcels in the project. *Relative fair value before construction* is the fair value of each land parcel in a real estate project in relation to the fair value of the other parcels in the project, exclusive of value added by on-site development and construction activities.

c. *Incidental operations.* Minor revenue-producing activities engaged in during the holding or development period to reduce the cost of developing the property for its intended use, as distinguished from activities designed to generate a profit or a return from the use of the property.

d. *Incremental revenues and costs of incidental operations.* Revenues that would not be produced, or costs that would not be incurred, except in relation to the conduct of incidental operations. Costs that are not incremental are interest, taxes, insurance, security, and similar costs that would be incurred during the development of a real estate project regardless of whether incidental operations were conducted.

Nature of Real Estate Acquisition, Development, and Construction Activities

.06 Real estate acquisition, development, and construction activities occur in four stages: (*a*) predevelopment, (*b*) development, (*c*) construction, and (*d*) sales or rental operations. Distinguishing between different stages, or distinguishing the beginning and end of some stages, may often be difficult because similar costs may be incurred in different stages.

.07 During the predevelopment stage, the purchaser investigates the property, negotiates for its acquisition, and finally enters into a formal contract to acquire the property. In addition to the agreed consideration, the purchaser incurs costs for related legal, recording, and title services. Costs also may be incurred for such activities as appraisals, market feasibility studies, architectural and engineering services, soil tests, and zoning changes. Some of those costs may be incurred before there is a formal commitment to acquire the property.

.08 Real estate builders and developers may acquire property well in advance of the beginning of construction and hold the property for an extended period while preparing development and building plans and obtaining zoning changes and other required permits. During that period, costs are incurred for those activities and for such items as interest and property taxes.

.09 On-site and off-site improvements, such as roads, sewers, utilities, grading, and site clearance, are made before the construction stage. Zoning approvals and building permits may require the developer to set aside land for community facilities (such as schools, parks, and roads) to be donated to local authorities or governmental units. Developers may be required to contribute funds to governmental units to help finance the construction of facilities, such as sewer plants and schools, to serve the property.

.10 Real estate developers may receive revenue from, and incur costs for, incidental operations relating to real estate, such as the operation of temporary parking lot facilities or the leasing of undeveloped land for grazing or farming.

.11 Real estate projects may include amenities, such as golf courses, tennis courts, indoor recreational facilities, parking facilities, and utility plants. Some amenities are sold to tenants' or homeowners' associations; others are intended to be self-supporting enterprises. Some or all of the costs of other amenities are expected to be recovered from lease or sale.

.12 Differentiating between costs to be charged to expense and costs to be capitalized and associating capitalized costs with particular assets pose complex problems in accounting for real estate projects. Real estate projects generally require several accounting periods to complete. In addition, large real estate projects usually involve multiple purchases and sales that require complex cost accumulation and allocation techniques. Development and construction plans and costs and revenues are affected by such factors as market conditions, inflation, interest rates, zoning restrictions, terrain, and location. For example, a residence next to a golf course or an office near the top of an office tower usually generates more revenue than a similar unit otherwise situated.

Present Accounting Practices

Cost Capitalization

.13 Except for the general practice of capitalizing direct acquisition, development, and construction costs, cost capitalization practices vary widely. Some entities capitalize property-related costs incurred before the acquisition of the property and include them in the cost of the property when it is acquired. Some entities capitalize as property costs expenditures during the development and construction phases for interest, taxes, insurance, and indirect project costs (indirect costs related to project development and construction). Others capitalize only some or none of those costs. An entity may have different capitalization practices for different projects or for different components of a particular project.

.14 Accounting for revenues and expenses of amenities and incidental operations also varies. Some enterprises account for such revenues and expenses as decreases or increases in capitalized project costs, and others include them in current operating results.

Allocation of Capitalized Costs

.15 Real estate developers generally use one or more, including a combination, of the following methods to allocate capitalized costs: area, value, and specific identification. Under area methods, common costs are allocated to individual units based on the number of units or size, such as acreage or square footage. Under value methods, costs are allocated to individual units based on the relative value of the individual units. Under specific identification methods, costs identified with a specific property are assigned to that property. Common costs associated with the entire development, such as access roads, utility trunk lines, and amenities, usually are allocated by area and value methods.

The Division's Conclusions

.16 As a general rule, costs clearly associated with the acquisition, development, and construction of a real estate project should be capitalized. The division believes, however, that the recommendations in this statement should be applied to the following: (*a*) preacquisition costs, (*b*) interest, taxes, and insurance, (*c*) indirect project costs, (*d*) amenities, (*e*) incidental operations, (*f*) allocation of capitalized costs to components of a real estate project, (*g*) revisions of estimates, (*h*) costs in excess of estimated net realizable value, (*i*) abandonments and changes in use, and (*j*) cost of sales.

Preacquisition Costs

.17 Payments to obtain an option should be capitalized as incurred. Other costs related to a property that are incurred before the enterprise acquires the property, or before the enterprise obtains an option to acquire it, should be deferred, provided all three of the following conditions are met:

a. The costs are directly identifiable with the specific property.

b. The costs would be capitalized if the property were already acquired.

c. Acquisition of the property or of an option to acquire the property is probable.[1] For this condition to be met, the prospective purchaser must be actively seeking to acquire the property and must have the ability to finance or obtain financing for the acquisition under circumstances in which there is no evidence indicating that the property is not available for sale.

If any one of these three conditions is not met, costs incurred before a property is acquired should be charged to expense as incurred.

.18 Option costs and the accumulated amount of deferred preacquisition costs (*a*) should be capitalized as project costs on acquisition of the property or (*b*) to the extent not recoverable by sale of the options, plans, and so forth, should be charged to expense when it is probable that the property will not be acquired. The amount of option costs and deferred preacquisition costs should be disclosed in the financial statements.

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[1]*Probable* is defined for accounting purposes in Statement of Financial Accounting Standards 5 as "likely to occur" and is used in the same sense in this statement.

Interest, Taxes, and Insurance

.19 Statement of Financial Accounting Standards 34, *Capitalization of Interest Cost*, prescribes the accounting for interest cost. Costs incurred on real estate for property taxes, insurance, and similar items should be capitalized as property cost only during periods in which activities necessary to get the property ready for its intended use are in progress. Costs incurred for such items after the property is substantially complete and ready for its intended use should be charged to expense as incurred.

Indirect Project Costs

.20 *Indirect project costs* are indirect costs incurred after the acquisition of the property, such as construction administration, legal fees, and various office costs (cost accounting, design, and other departments providing services to projects), that clearly relate to projects under development or construction. Some indirect project costs clearly relate to a specific project, such as costs associated with a field office at a project site and the administrative personnel that staff the office, and they should be capitalized as a cost of that project. Other indirect project costs may relate to several projects and should be capitalized and allocated to the projects to which the costs relate in a rational manner based on the nature of activity that gave rise to the costs. To illustrate, 60 percent of a construction administration department's time is spent managing internal projects under current development, 35 percent is spent managing projects for others for a fee, and 5 percent is spent administering the maintenance of operating properties; 60 percent of the costs should be capitalized and allocated to the project, and 40 percent should be charged to expense as incurred.

.21 Indirect costs that do not clearly relate to projects under development or construction and all general and administrative costs should be charged to expense as incurred.[2] General and administrative costs include such costs as entity management salaries, general accounting, corporate office expense, general legal services, and similar costs of the type generally incurred by all enterprises for the conduct of business.

Amenities

.22 Accounting for costs of amenities, such as golf courses, utility plants, clubhouses, swimming pools, and tennis courts,

[2] Costs to sell and rent real estate projects should be accounted for in accordance with AICPA Statement of Position 78-3 [section 10,180], *Accounting for Costs to Sell and Rent, and Initial Rental Operations of, Real Estate Projects.*

should be based on management's plans for the amenities in accordance with the following:

a. If an amenity is to be sold or transferred in connection with the sale of individual units, costs (including expected future operating costs to be borne by the developer until they are assumed by buyers of units in a project) in excess of anticipated proceeds should be allocated as common costs since the amenity is clearly associated with the development and sale of the project.

b. If an amenity is to be sold separately or retained by the developer, capitalizable cost of the amenity in excess of its estimated fair value, as of the expected date of its substantial physical completion, should be allocated as common costs.[3] For the purpose of determining the amount to be capitalized as common costs, the amount of cost allocated to the amenity should not be revised after it is substantially completed and available for use. A later sale of the amenity at more or less than its estimated fair value as of the date of substantial physical completion, less any accumulated depreciation,gives rise to a gain or loss that should be included in net income in the period in which the sale occurs.

As indicated in paragraph .26 of this statement, common costs should be allocated on the basis of relative fair value (before construction) of each land parcel benefitted. In allocating costs of amenities as common costs, land parcels benefitted should be limited to those for which development can reasonably be expected.

.23 Before an amenity is substantially completed and available for use, operating results of the amenity should be included as a reduction of, or addition to, common costs. When an amenity to be sold separately or held for investment is substantially completed and available for use, current operating income and expenses of the amenity should be included in current operating results, since the operations of the amenity no longer clearly relate to the development and sale of the project as a whole but, rather, relate to the objective of making a profit on operations or sale of the amenity itself or of using the amenity as a sales promotional tool.

.24 The following assumed data are used to illustrate the application of the recommended accounting for the costs of amenities:

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[3]The accounting for costs of amenities to be sold separately or retained by the developer recommended in this statement differs from the accounting for costs of such amenities under the AICPA industry accounting guide, *Accounting for Retail Land Sales*, because of differences in circumstances. This statement does not apply to transactions to which that guide applies.

a. A single family residential project is to include a recreation center, consisting of a swimming pool and tennis courts, with an estimated cost of $250,000.

b. The center is to be transferred to a homeowners' association in connection with the sale of the units in the project.

c. Each purchaser of a unit will be obligated to pay a monthly assessment fee.

d. The developer agrees to pay net operating costs before the expected date of transfer and the monthly assessment fees for all unsold units. Such support is estimated to cost $50,000.

Based on these assumptions, the total estimated cost of $300,000 (the $250,000 cost of the center plus $50,000 in support costs to be paid by the developer) should be allocated as common costs based on the relative fair value of each lot benefitted. The accounting would differ, however, if the assumptions were modified as follows:

a. The center is to be retained by the developer.

b. Net operating costs are estimated to be $30,000 before substantial physical completion and $20,000 after substantial physical completion.

c. The fair value of the center at the date of substantial physical completion is estimated to be $200,000.

Under the modified assumptions, $80,000, the amount by which the costs of the center plus the estimated net operating costs before substantial completion ($250,000 plus $30,000) exceed the estimated fair value at the date of substantial physical completion ($200,000), should be allocated as common costs. Actual operating losses incurred after substantial physical completion should be included in current operating results.

Incidental Operations

.25 An excess of incremental revenue over the incremental costs of incidental operations, such as the operation of temporary parking lot facilities or the leasing of undeveloped land for grazing or farming, should be accounted for as a reduction of capitalized project costs. An excess of incremental costs over incremental revenue should be charged to expense as incurred, since it did not achieve the objective of reducing the cost of developing the property for its intended use.

Allocation of Capitalized Costs to the Components of a Real Estate Project

.26 To the extent that this is practicable, the costs of acquisition, development, and construction of real estate projects should be capitalized and assigned to individual components of the project on the basis of specific identification. Land cost and all other common costs should be allocated on the basis of the relative fair value (before construction) at the date of allocation to each land parcel benefitted.[4] The division believes that allocation on the basis of relative fair value is consistent with the generally accepted principle for allocating joint costs to separable outputs and assigns joint costs to individual parcels, phases, and units on the basis of their potential revenue contributions.

.27 A land parcel may be considered to be an individual lot or a "phase," defined for this purpose as a parcel on which units are to be constructed concurrently. It may be necessary to accumulate costs in one or more cost centers before final allocation if some costs apply to different portions of a project, for example, if some costs apply only to certain components of a project and other costs apply to other components or to the entire project.

.28 Construction costs should be assigned to the individual units in a phase on the basis of specific identification, if practicable. Otherwise, construction costs applicable to the phase should be allocated to individual units in the phase in a reasonable manner that achieves results comparable to allocation on the basis of the relative sales value of the individual units to the sales value of the total units in the phase.

.29 For the purpose of illustrating the general principles, a developer is assumed to have under development a single-family residential subdivision for which assigning costs to individual units by specific identification is impracticable. The smallest practicable unit for that purpose is a group of units to be constructed as a separate phase and sold individually. Based on those assumptions, the cost allocations might be as follows:

a. On-site and off-site costs specifically identified with the units in the phase would be allocated to the phase.

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[4] The AICPA industry accounting guide, *Accounting for Retail Land Sales*, permits the use of other methods of allocating common costs (for example, the area method) that fairly match costs with related revenues. This statement does not apply to transactions to which that guide applies.

b. Common costs of the entire project (or a parcel) of which the phase is a part would be allocated to the phase on the basis of the relative fair value of the land in the phase (before construction) to that of the project (or parcel).

c. Costs allocated to the phase would be allocated to an individual unit on the basis of the relative sales value of the unit to that of all units in the phase. If a phase includes both units to be sold and units to be held for investment, the final allocation would be made to the investment units on the basis of the relative fair value of the investment units to the total of the sales value of the units to be sold and the fair value of the investment units.

This illustration applies only to costs for which assignment to individual units on the basis of specific identification is not practicable. To the extent that it is practicable, all costs should be assigned to individual units on the basis of specific identification.

Revisions of Estimates

.30 Estimates and cost allocations should be reviewed at the end of each financial reporting period until a project is substantially completed and available for sale. Costs should be revised and reallocated as necessary for material changes on the basis of current estimates. Changes in estimates should be accounted for in accordance with paragraph 31 of APB Opinion 20, *Accounting Changes*, which states

> The effect of a change in accounting estimate should be accounted for in (*a*) the period of change if the change affects that period only or (*b*) the period of change and future periods if the change affects both. A change in an estimate should not be accounted for by restating amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods.

Most revisions of estimates relating to real estate cost allocations affect both the period of the change and future periods, and their effects should therefore be accounted for prospectively in the period of the change and future periods. For example, an increase in the estimate of the common costs of a project should be allocated to current and future periods even though the allocation results in lower profit margins on current and future sales than on prior sales from the project. However, increases in costs without comparable increases in market value can raise questions about whether the estimated total cost of property not yet sold exceeds its net realizable value.[5]

.31 When an enterprise records sales of real estate and records in cost of sales accruals for estimated costs to be incurred (which may include a portion of estimated common costs allocable to the property sold—see paragraph .35 of this statement), changes in estimates of those costs should be recorded in cost of sales in the period in which the differences become known, since they are unrelated to future operating results.[6] To illustrate, the following circumstances are assumed: (*a*) sales of property were recorded in full in prior periods and did not require any deferral of revenue for future performance and (*b*) estimated costs of $200,000 have been accrued relating to the sales revenue previously recorded. If current estimates of such costs are $250,000, an additional $50,000 should be accrued and charged to cost of sales in the current period.

Cost in Excess of Estimated Net Realizable Value

.32 Capitalization of costs associated with the development and construction of a property should not cease when present accounting principles require recognition of a lower value for the asset than acquisition cost.[7] When the capitalized cost of real estate held for sale or for development and sale exceeds its estimated net realizable value, an allowance should be provided to reduce the carrying amount to estimated net realizable value, determined on the basis of an evaluation of individual projects. An individual project, for this purpose, consists of components that are relatively homogeneous, integral parts of a whole (for example, individual houses in a residen-

[5] In accounting for sales of real estate in circumstances in which the seller has an obligation of future performance to complete improvements and amenities of a project, the seller may be required to record a portion of the sales price as deferred revenue based on the ratio of the estimated cost of the future performance to total cost. (See the AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate*.) Revisions of estimated costs to complete project improvements and amenities may relate to previously recorded deferred revenue. In those cases, the relationship of the two elements comprising the deferred revenue—costs and profit—should be recalculated to determine the amount of the deferred revenue to be recognized as the costs are incurred. However, if the revised estimated cost of future performance exceeds the remaining applicable deferred revenue, the excess should not be deferred but, rather, should be charged to income immediately.

[6] If, in accordance with paragraphs 47 through 50 of the AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate*, all or a portion of the revenue for a sales transaction is deferred because the seller has an obligation for future performance, the costs related to the revenue should be recognized when the sales revenue is recognized.

[7] For real estate held for sale or development and sale, the lower value to be recognized is net realizable value (NRV). NRV is the estimated selling price in the ordinary course of business less estimated costs of completion (to the stage of completion assumed in determining selling price), holding, and disposal.

tial tract, individual units in a condominium complex, and individual lots in a lot subdivision). Therefore, a multiphase development consisting of a tract of single-family houses, a condominium complex, and a lot subdivision generally would be evaluated as three separate projects.

Abandonments and Changes in Use

.33 Real estate, including rights to real estate, may be abandoned, for example, by allowing a mortgage to be foreclosed or by allowing a purchase option to lapse. Capitalized costs, including allocated common costs, of real estate abandoned should be written off as current expenses or, if appropriate, to allowances previously established for that purpose and should not be allocated to other components of the project or to other projects, even if other components or other projects are capable of absorbing the losses. Donations of land to municipalities or other governmental agencies for uses that will benefit the project are not abandonments. The cost of the land donated should be allocated as a common cost of the project.

.34 Changes in the use of real estate comprising a project or a portion of a project may arise after significant development or construction costs have been incurred. In such circumstances, development and construction costs incurred before the change should be written off, except as follows:

a. If the change is made pursuant to a formal plan for a project that is expected to produce a higher economic yield, the write-off may be limited to the amount by which the capitalized costs incurred and to be incurred exceed the estimated value of the revised project at the date of substantial physical completion.

b. In the absence of a formal plan for a project that is expected to produce a higher economic yield, the write-off may be limited to the amount by which total capitalized costs exceed the estimated net realizable value of the property, determined on the assumption that it will be sold in its present state.

To illustrate, the total capitalized costs of a golf course are assumed to be $1 million, including development and construction costs of $700,000 and land costs of $300,000. If, pursuant to a formal plan, the golf course is to be torn up in order to build single-family residences for sale, and such use would recover the capitalized costs of the golf course as well as the construction and development costs of the new project, the $1 million may be included in the cost of the new project. If, on the other hand, golf course operations are terminated by reason of continuing operating losses without a formal plan for a project expected to produce a higher economic yield, the $700,000 of development and construction costs should be written off to the extent that the total unrecovered costs of $1 million exceed the estimated net realizable value of the property in its present state.

Cost of Sales

.35 Costs applicable to real estate should be charged to cost of sales when the related sales revenue is recorded in operating results.[8] Such costs include the allocated portion of costs incurred plus accruals (including revisions—see paragraph .31) for estimated costs to be incurred for the real estate sold.

Transition

.36 The accounting standards division recommends the application of the provisions of this statement prospectively for fiscal years, and interim periods in those fiscal years, beginning after December 24, 1980. Earlier application is encouraged for fiscal years beginning before December 25, 1980, for which financial statements have not been issued. Costs capitalized or deferred in accordance with generally accepted accounting principles in years before the fiscal year for which the provisions of this statement are first applied should not be written off, even though such costs do not qualify for capitalization or deferral according to the conclusions in this statement. Such capitalized costs should be reallocated to components of real estate projects in accordance with the conclusions in this statement unless it is not practicable to do so. Changes in estimates and reallocations made to conform with the conclusions in this statement should be accounted for as revisions of estimates, as discussed in paragraphs .30 and .31 of this statement. Costs charged to expense in years before the fiscal year for which the provisions of this statement are first applied should not be capitalized or deferred to conform to the conclusions in this statement.

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[8] For a discussion of circumstances under which recognition of revenue is deferred because of the seller's obligation for future performance, see note 6.

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ACC TOPICAL INDEX

STATEMENTS OF POSITION

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